NYSBA SUMMER 2002 | VOL. 35 | NO. 2

# 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

It is an honor, privilege and pleasure to chair one of the most productive, hard-working and respected Sections of the New York State Bar Association.

The work of our Section is based upon the committee system which is very unique in its open membership and unlimited term of service. Any member of the Section can serve on any one or more committees of such member's choice and service on any committee can last as long as the member chooses to serve. The Section's 17 standing committees, which are listed on p. 61 of this *Newsletter*, are diverse and reflect the varied, complex and extensive nature of our practice and interests. The committees, in general, propose affirmative legislation, prepare and submit reports on legislation proposed by other groups, research and publish scholarly reports and articles, conduct surveys, as well as assist in the preparation and presentation of our Section's Spring and Fall seminars and the many continuing legal education programs and publications sponsored by the Bar. Members of the committees meet at the Annual, Spring and Fall Meetings of the Section and throughout the year depending on the particular project.

Our Section also works through special ad hoc committees, one of the most productive being the Hot Docs® project spearheaded by Wallace Leinheardt, in conjunction with Matthew Bender, from which we have all benefited. Our congratulations to Wally on his being honored with the Bar's 2002 Pro Bono Service Award for his September 11-related efforts and accomplishments. Our ad hoc committee on the new Principal and Income Act (with its unitrust component), chaired by Arthur Bongiovanni, has recently labored on the technical corrections to the Act, which the EPTL-SCPA Legislative Advisory Committee has considered, and will continue to work on any possible future changes in the Act. Our Technology Committee, chaired by David Goldfarb, is working with the Bar Association in creating a list service for our expanded Executive Committee and

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NYSBA 125 Years

perhaps the entire Section as well as many other technological advances of benefit to our membership.

We urge any member who wishes to serve on a committee to contact either the chair of the committee or me.

Our Spring Meeting in Binghamton had the greatest attendance in recent years, which is to the credit of our exceptional program chairs, Michael H. Zuckerman and Kathryn Grant Madigan. Susan Frunzi provided insight into the complexity of planning in view of the potential repeal of the estate and generation-skipping transfer taxes; Richard Rothberg gave an amusing and informative talk on drafting for the new Principal and Income Act and the Unitrust; John Spitzmiller spoke on recent estate and trust developments; our luncheon speaker, former Section Chair, Surrogate Eugene Peckham provided important advice on planning after disability and Article 81 proceedings; Gary Carpenter, a Syracuse accountant, covered the opportunities presented by section 529 plans and alternative educational savings plans; and the program ended with Georgiana Slade's thorough presentation on planning opportunities and considerations after execution of an irrevocable life insurance trust.

We look forward to our Fall Meeting in Boston from October 3–6, 2002, where Gary Freidman and Barbara Levitan, as Co-Chairs of the program, have assembled a stellar panel of speakers dealing with administering the problem estate. We have planned dinners at the JFK Library and Museum and the Boston Museum of Fine Arts as well as our famous tennis and golf tournaments. I hope to see you all there.

**Arlene Harris**

## Upcoming Meetings of Interest

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|---|---|
| October 3–6, 2002 | New York State Bar Association Trusts and Estates Law Section. Fall Meeting. Boston, Massachusetts. |
| October 29–30, 2002 | "Probate and the Administration of Estates" New York State Bar Association. Seven locations throughout the state. It is an evening program running from 5:30–9:30 p.m. each day. |
| September 11–14, 2003 | New York State Bar Association Trusts and Estates Law Section. Fall Meeting. Victoria, British Columbia. |
| October 2004 | New York State Bar Association Trusts and Estates Law Section. Fall Meeting. Savannah, Georgia. |

# Editor's Message

I am very appreciative of all of the authors' efforts which resulted in this issue on varied topics.

This issue includes a very detailed article on planning considerations after the creation of a life insurance trust, which Georgiana J. Slade has written for us. Georgiana is well versed in this area and is an author of the BNA portfolio on the topic which so many of us use. David Pratt, who is the Chair of the Life Insurance and Employee Benefits Committee, has written on the topic of bankruptcy and the effect on retirement assets. It is a very interesting article which has application in today's economic climate. A bill regarding disqualification of an abusive parent from inheritance has been proposed. It is aptly described in an article by Staci Graber and I thank her for taking the time to write. I understand that the legislature may expand coverage to exclude any parent whose parental rights have been terminated. A new and different entry for this *Newsletter* is John Grall's topical book review of the novelist, Sarah Caudwell. Many of her murder mysteries involved London barristers and tax planning.

Most issues of the *Newsletter* include a description of one of different committees of the Section for your consideration. The success of this Section is due, in part, to the activities of its many standing committees. In this issue, David Goldfarb, who is Chair of the Technology Committee, has advised me of its projects.

The Technology Committee worked on the redesign of the Web page for the Trusts and Estates Law Section on the NYSBA Web site. This was part of the NYSBA process of redesigning its Web site and providing other related services to its members. The new site is a state-of-the-art member resource with systems for homepage personalization (MyNYSBA pages), newsletter management, content management, discussion groups, members-only Section extranet management, direct third-party content delivery, and e-commerce shopping cart technology. As part of direct third-party content delivery, Loislaw is providing extra functionality to the Trusts and Estates Law Section's Web site via its LawWatch program. There are plans for online notification to Section members of new case law (and possibly legislative) developments. The Technology Committee will be working to design the proper search terms for this function. The NYSBA Web site also has "individualized" Web pages. Members are "tagged" according to their areas of interest (Section membership, geographical interests) and the tagging of content allows for the creation of corresponding dynamically created category-specific Web pages matched to members' particular interests. The Technology Committee will be developing individualized information that the Section would want to provide to our members. If any of you are computer persons, David can always use help to complete the projects undertaken by the Committee.

Summer will pass all too quickly, but remember that October brings the Fall Meeting of the Section. We will meet in Boston. The program promises to be enlightening, and Arlene Harris has arranged for dinner in the new Jackie Wing of the J.F. Kennedy Library and a cocktail reception at the Museum of Fine Arts. Sports are also being included. Tennis and golf have been reserved. Mark your calendars for October 3–6 and join us in Boston.

**Magdalen Gaynor**

## Notice

The American Red Cross is preparing to issue flat gift payments of $45,000 to each of the estates of those killed as a result of the September 11 attacks and has asked for this notice to be sent to those who could provide the information the American Red Cross needs to reach every estate of those killed in the attacks. Specific information about the executors/executrixes and/or representatives of these estates can be sent to:

**Daniel Zellman**
**Financial Assistance Program**
**American Red Cross**
**100 Varick Street**
**New York, NY 10013**
**zellmand@usa.redcross.org**
**(212) 875-2019**

# Disqualification of a Parent—Proposed Legislation

By Staci A. Graber

Under the current state of the law, an abusive parent, whose rights have been legally terminated by a court of competent jurisdiction, is not precluded from inheriting from his or her child's estate. New York's Estates, Powers & Trusts Law 4-1.4 (EPTL) provides for disqualification of a parent who fails or refuses to support a child or those who have abandoned a child. The statute has not been amended to address what the courts have already deemed an additional ground for disqualification, abuse. With the growing number of reported cases of abuse, children today are in need of every additional protection the law can provide. Current case law, driven by public policy, has responded to this need by dictating that an abusive parent be disqualified from inheriting from a child's estate. The Trusts and Estates Section of the New York State Bar Association[1] has proposed an amendment to EPTL 4-1.4 to expand the grounds for disqualifying a parent as an intestate distributee where he or she is found to have physically abused the child or allowed continued abuse of such child.

> *"The willingness of our courts to extend disqualification to cases of abuse without having the ground specifically enumerated in the statute reveals a gap in the law."*

EPTL 4-1.4(a) now provides, in relevant part, that a parent is disqualified as an intestate distributee where the parent has "failed or refused to provide for, or has abandoned his or her child while that child is under the age of twenty one, whether or not that child dies before reaching the age of twenty one." As will be discussed in detail, a number of cases address instances of disqualification which fall outside the grounds specifically enumerated in the statute, yet remain within the spirit of the law. A current trend indicates that the courts are expanding the grounds for disqualification, and at the same time addressing child abuse, by prohibiting the parent from inheriting from a child after a finding of abuse has been made.

The willingness of our courts to extend disqualification to cases of abuse without having the ground specifically enumerated in the statute reveals a gap in the law. A parent may take an intestate share from his or her child even when his or her rights have been terminated by the family court[2] pursuant to Social Services Law § 384-b (SSL) and the child was permanently removed from the home due to abuse. The proposed amendment to EPTL 4-1.4(a)(2) seeks to include abuse as grounds for disqualification to preclude an abusive parent from sharing the right of inheritance under such circumstances. As amended, EPTL 4-1.4 would provide as follows:

> Disqualification of parent to take intestate share
>
> (a) No distributive share in the estate of a deceased child shall be allowed to a parent if the parent, while such child is under the age of twenty-one years:
>
> (1) has failed or refused to provide for the child or has abandoned such child, whether or not such child dies before having attained the age of twenty-one years, unless the parental relationship and duties are subsequently resumed and continue until the death of the child; or
>
> (2) has been the subject of a proceeding pursuant to Section 384-b of the Social Services Law which
>
> (A) results in an order terminating parental rights on the basis of abuse, or
>
> (B) results in an order suspending judgment as to parental abuse of the child, in which event the Surrogate's Court may make a determination disqualifying the parent on the basis of abuse as adjudicated by the Family Court, unless the Surrogate's Court finds that the parent, during the period of suspension, has by clear and convincing evidence taken the necessary steps in accordance with the Family Court order to restore the parent-child relationship.
>
> (b) Subject to the provisions of subdivision eight of section two hundred thirteen of the civil practice law and rules, the provisions of subdivision (a)(1) of this section shall not apply to a biological parent who places the child for adoption based upon: (1) a fraudulent promise, not

kept, to arrange for and complete [the] adoption of such child, or (2) other fraud or deceit by the person or agency where, before the death of the child, the person or agency fails to arrange for the adoptive placement or petition for the adoption of the child, and fails to comply timely with conditions imposed by the court for the adoption to proceed.

(c) In the event that a parent or spouse is disqualified from taking a distributive share in the estate of a decedent under this section or 5-1.2, the estate of such decedent shall be distributed in accordance with 4-1.1 as though such spouse or parent had predeceased the decedent.

The proposed amendment is intended to disqualify an abusive parent from inheriting from his or her child's estate. As noted above, a parent may inherit from his or her child's estate even where his or her parental rights were terminated by the family court on the grounds of abuse. Other than those grounds enumerated in the statute to disqualify a parent, a legal adoption is the only legal means to terminate inheritance rights of a natural parent from a child. Because an order to terminate parental rights on the grounds of abuse occurs before a child can be legally adopted, the proposed amendment would provide that where a family court ordered the termination of a parent's rights on the ground of abuse, disqualification would immediately occur, as opposed to waiting for a formal adoption to take place. It is at this stage where the injustice may occur as a child may not be formally adopted for years after his or her parent's rights have been terminated. Some children are never adopted after the parent's rights were terminated and they may live with a foster family until attaining majority. This is the situation the amendment is intended to address. Such a parent may benefit from the right to inherit from a child's estate despite having been relieved of any obligation to care for or support the child. As will be discussed, the trend in case law recognizes that public policy would not be furthered by permitting an abusive parent(s) from inheriting from a child's estate. Once termination of a parent's rights occurs, disqualification should follow and such parent should be precluded from reaping any benefit from a child's untimely death.

The concept of disqualification originated in 1929 pursuant to section 87 of the Decedent's Estate Law (DEL),[3] and initially affected only a spouse's right to inherit. The statute was amended several times and subdivision (e) was added to include the situation where a parent forfeits a share in the estate of his or her child.[4] Subdivision (e) provided in part that no distributive share of the estate of a child would be allowed to a parent who has neglected or refused to provide for the child during infancy or who has abandoned the child during infancy.[5] Inclusion of parental disqualification under DEL § 87 was amended to deprive a parent of a distributive share and to prevent a parent from profiting from his or her own wrong. In such cases, disqualification resulted in the distribution of the child's estate as though the parent predeceased the child.

No definitions were provided for what constituted "neglect" or "abandonment" under DEL § 87. However, the terms were defined under DEL § 133(4)(c), currently EPTL 5-4.4, which provided that a parent is ineligible to share in the distribution of damages recovered in an action involving the estate of a child who has been abandoned by his or her parent. Abandonment of a child was defined as a "voluntary breach or neglect of duty to care for and train the child and of a duty to supervise and guide his growth and development."[6] Early cases further interpreted abandonment to include "neglect and refusal to perform natural and legal obligations to care and support, withholding his presence, his care, opportunity to display voluntary affection, and neglect to lend support and maintenance."[7] Under both DEL § 87 and DEL § 133, neglect, refusal to support, and abandonment are separate and distinct grounds for disqualification.

The ground of neglect as a basis for disqualification was subsequently omitted from the recodification of DEL § 87 to EPTL 4-1.4. Despite the omission of neglect as a statutory ground for disqualification, courts have disqualified a parent under EPTL 4-1.4(a) on the basis of neglect. In doing so, courts rely upon public policy and the well-settled principle that one may not profit from his or her wrong, a doctrine established in *Riggs v. Palmer*[8] in 1889, prior to the codification of disqualification in the DEL.

In *Riggs*, a beneficiary under a will was convicted of murdering the testator so that he could accelerate distribution of the estate. [9] At the time, no specific statute was in place to provide guidance to the court regarding disqualification, only general laws of devolution of property. Notwithstanding, the court held that "it could not have been the intention of the legislature in the general laws passed for the devolution of property by will or descent, that they should operate in favor of one who murdered his ancestor in order to come into possession of his estate." Therefore, the court was not concerned with the general language contained in the existing laws, but public policy which guided the court's decision. The principle in *Riggs* has been codified under EPTL 4-1.6

which provides that a joint tenant convicted of murder in the first degree or second degree as defined in Penal Law § 125.27 and § 125.25,[10] respectively, shall not be entitled to the distribution of any monies associated with that tenancy except for the monies contributed by the convicted joint tenant.

Since *Riggs* was decided by determining whether a forfeiture results from the beneficiary's conduct, courts have created a distinction between those persons who act with intent to cause harm as opposed to those who commit acts which are accidental, involuntary or done in self-defense. For example, in *In re Fitzsimmons*,[11] the court held that a beneficiary who caused decedent's death would not forfeit a distributive share if the killing was accidental or in self-defense. The rationale is that one who acts under such circumstances does so without *intent* to cause the harm. The same result arises where a defendant-beneficiary is determined to be incompetent or insane. Such person is deemed to act without knowing the nature and quality of his or her act, thereby committing no legal wrong. Thus, the principle of profiting from his own wrong is inapplicable.[12]

The basis for disqualification, however, has been extended to include those persons who act with reckless disregard for the life of another. In *In re Wells*,[13] the defendant-beneficiary was convicted of manslaughter in the second degree, a non-intentional felony. The court found that the defendant was not entitled to share in the decedent's estate because, while the crime was not considered an intentional felony, it involved a "reckless and conscious disregard for the life of another."[14] Section 15.05(3) of the N.Y. Penal Code states that "a person acts recklessly with respect to a result or to a circumstance described by a statute defining an offense when he is aware of and consciously disregards a substantial and unjustifiable risk that such result will occur or that such circumstance exists."[15] Because the defendant in *Wells* was consciously aware of the risk and possible result of her actions, her conviction for second degree manslaughter would bar inheritance despite the lack of intent.[16]

In a similar case, *In re Grant*, a man was convicted of second degree manslaughter in the death of his wife and was barred from receiving his distributive share in both his wife's estate and as the beneficiary to the proceeds of a life insurance policy. The court explained that although the second degree manslaughter conviction did not automatically bar inheritance because it is not an intentional crime, public policy dictates that the principle of disqualification be applied to prohibit a beneficiary from profiting from such 'reckless' conduct which caused another's death.[17] The surrogate reasoned that the defendant should not be in a better position as a result of his crime.[18]

A parent permitted to inherit from his or her child after having had his or her parental rights terminated due to abuse is adverse to the policy underlying the statute and case law based on the reasoning of *Wells* and *Grant*. The type of reckless behavior outlined in these cases is analogous to that of a parent who abuses his or her child to such an extent that the court terminates that parent's rights. Allowing inheritance rights to such a parent permits him or her to profit from such wrongdoing. The principle underlying disqualification of a person whose reckless conduct results in another's death, is the basis for amending EPTL 4-1.4(a) to include disqualification of a parent whose parental rights were terminated pursuant to SSL § 384-b. A parent who abuses a child, whether or not that parent ultimately causes the child's death, does so with reckless disregard for the life of that child.[19] Because the parent is aware of and consciously disregards the unjustifiable risk that death could occur, that parent, and a parent who condones the abuse by his or her inaction, should be automatically barred by statute from inheriting from the child's estate under the same principle that justifies forfeiture generally.

In *Mark G. v. Sobal*,[20] the issue concerned disqualification of a parent as a distributee of a child's estate where the parent was found to have abused the child during his or her lifetime. There, decedent's father pleaded guilty to manslaughter of his son due to severe physical abuse. The child's mother was found to have also previously inflicted physical abuse upon him during his lifetime. The Supreme Court held that the father was clearly disqualified as a distributee of the child's estate since a murderer may not inherit from the estate of his victim. The court continued and held "the same, general common-law principle disqualified the mother as a distributee in that she physically abused the boy and, most importantly, contributed significantly to his death."[21] With respect to the mother, the court added:

> While the instant situation may not be exactly what the drafters [of that statute] had in mind, it clearly fits within the ambit of the statute in wording and in spirit . . . as a matter of case and statutory law, *morality and common sense*, the mother may not inherit from her son's estate.[22]

Proposing to extend this principle by amending EPTL 4-1.4 to include parental abuse as a basis for disqualification, the drafters were concerned with two issues: (1) the potential burden upon the surro-

gate's court if a determination had to be made in each case as to whether abuse occurred during the life of the child, and (2) the right of the parent to have a fair hearing.

Although under the proposed amendment the surrogate would have discretion to disqualify a parent from inheriting on the basis of abuse, the statute makes clear that the family court has exclusive jurisdiction to terminate parental rights on the basis of abuse. It is necessary to rely on the family court's discretion in these matters because it is the family court which has procedural due process safeguards in place to protect the rights of all parties involved.

The procedure for terminating a parent's rights on the ground of abuse pursuant to SSL § 384-b is a thorough process. Complaints of abuse and/or neglect are filed with the court[23] whereby the child is removed from the home and placed in foster care. An authorized agency (e.g., Administration for Children's Services (ACS) or Department of Social Services (DSS)) then evaluates the home situation and makes a recommendation to the court as to the necessary steps to be taken by the parent(s) in order to strengthen the parental relationship and, specifically, what should be required of the parent in order to regain custody of the child. An order is made by the court based on the evaluation and recommendation of the family agency requiring the parent(s) to participate in one or more intervention classes. Where the family situation has not changed, and it appears that it would not be in the best interest of the child to return to the parent, a petition is filed with the family court which begins the proceeding for the commitment of the guardianship and custody of the permanently neglected or abused child (terminating the parental rights and allowing for the adoption of the child). The agency must state its recommendations and the diligent efforts which must be made to cure the household conditions. The petition must also set forth that the parent did not successfully meet the court-ordered requirements and the specific reasons why.

Once the parent is served with a summons, an attorney is assigned for those parents who cannot afford private counsel. A fact-finding hearing then takes place to determine whether the allegations made in the petition are supported by clear and convincing evidence. Assuming the evidence supports the agency's findings, a dispositional hearing is held in which, upon its conclusion, the court will enter a final order based solely on the best interests of the child. The court may, after looking at the totality of the circumstances surrounding each case, either: (1) dismiss the petition if the allegations are not established, (2) suspend its judgment for a period of no more than one year unless exceptional circumstances are found, or (3) commit the guardianship and custody of the child which terminates the parent(s) rights and frees a child for adoption. This lengthy process in abuse cases provides a parent with a full and fair opportunity to defend himself or herself from the charges brought.

*"The proposed amendment would provide a framework by which a court can disqualify a parent on the basis of abuse while preventing inconsistent decisions by the courts on the issue of disqualification."*

Clearly, disqualification of a parent would not occur in cases where a petition is dismissed. On the other hand, automatic disqualification would occur upon a court's termination of a parent's rights. However, a gap exists where the family court issues an order suspending judgment. In a case where judgment is suspended, the family court has entered a judgment sustaining the grounds for terminating parental rights but has suspended the effect of the judgment for a period of no less than one year, pending a final effort of the parent to restore the parent-child relationship. If a child dies during the time a suspended order is in effect, the family court no longer has jurisdiction over the deceased child and the matter is dismissed. In such situations, the proposed statute provides that the surrogate could make a final determination on the issue of abuse and decide whether the parent should be disqualified. The determination would be based on the record and determination of the family court and any additional evidence presented (i.e., the number of parental attempts during this period to fulfill the conditions of the family court order). At the time the issue as to disqualification reaches the surrogate's court for determination, parental abuse has already been adjudicated by the family court on the basis of clear and convincing evidence, thereby ensuring that no undue burden is placed upon the surrogate's court to make such determination.

As compared to instances of neglect, abandonment and refusal to support, there is no statutory or judicial precedent in New York for disqualification of a parent on the ground of abuse. The proposed amendment would provide a framework by which a court can disqualify a parent on the basis of abuse while preventing inconsistent decisions by the courts on the issue of disqualification. Until then, an abusive parent may be entitled to inherit from his or her child's estate.

## Endnotes

1. The author wishes to acknowledge the efforts of her colleagues on the Commissions Sub-Committee of the Trusts and Estates Section who drafted the proposed amendment.
2. The family court is referred to although the Supreme Court may also make such decisions pursuant to article 6 of the Family Court Act.
3. DEL § 87.
4. DEL § 87(e).
5. *Id*.
6. DEL § 133; *see also In re Herbster's Estate*, 121 N.Y.S.2d 360 (Surr. Ct., Monroe Co. 1953).
7. *Id*.
8. *Riggs v. Palmer*, 115 N.Y. 506, 22 N.E. 188; *see also Matter of Loud*, 70 Misc. 2d 1026, 334 N.Y.S.2d 969 (Surr. Ct., Kings Co. 1972).
9. *Id*.
10. N.Y. Penal Law § 125.27 and 125.25
11. 64 Misc. 2d 622, 315 N.Y.S.2d 590 (Surr. Ct., Erie Co. 1970).
12. *In re Estates of Pearl T. Fitzsimmons and William J. Fitzsimmons*, 64 Misc. 2d 622, 315 N.Y.S.2d 590 (Surr. Ct., Erie Co. 1970); *see also In re Wirth*, 59 Misc. 2d 300, 298 N.Y.S.2d 565 (Surr. Ct., Erie Co. 1969).
13. 76 Misc. 2d 458, 350 N.Y.S.2d 114 (Surr. Ct., Nassau Co. 1973).
14. Warrens Heaton p. 74-40.1; *see also In re Wells*, 76 Misc. 2d 458, 350 N.Y.S.2d 114 (Surr. Ct., Nassau Co. 1973); *In re Savage*, 175 Misc. 2d 880, 670 N.Y.S.2d 716 (Surr. Ct., Rockland Co. 1998).
15. Penal Law § 15.05(3).
16. Warrens Heaton p. 74-40.1; *see also In re Wells*, 76 Misc. 2d 458, 350 N.Y.S.2d 114 (Surr. Ct., Nassau Co. 1973); *In re Savage*, 175 Misc. 2d 880, 670 N.Y.S.2d 716 (Surr. Ct., Rockland Co. 1998).
17. *In re Grant*, N.Y.L.J., Apr. 12, 1984, p.12, col. 6 (Surr. Ct., Bronx Co.).
18. *Id*.
19. *See* SSL § 384-b(8)(a), defining a "severely abused" child as one who is abused as a result of the reckless or intentional acts of a parent.
20. 180 Misc. 2d 855, 694 NYS2d 290.
21. *Mark G. ex rel. Jones v. Sabol*, 180 Misc. 2d 855, 860, 694 N.Y.S.2d 290, 294.
22. *Id*. (emphasis added.)
23. *See* Family Court Act Article 10.

**Staci A. Graber is with Schram & Carew, P.C. in New York City**

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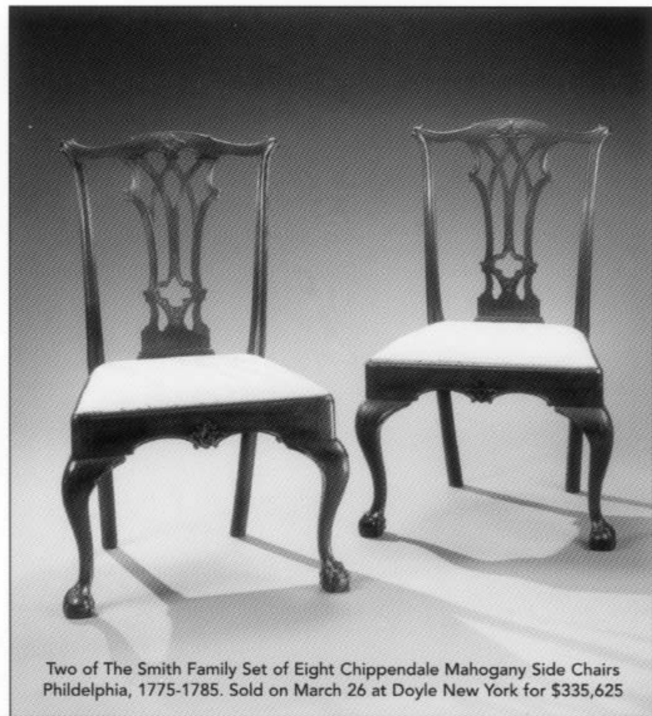

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# Irrevocable Life Insurance Trusts: Planning Opportunities and Considerations After the Trust Is Executed

By Georgiana J. Slade

## Introduction

Often attorneys believe that once an irrevocable life insurance trust (ILIT) has been executed their job is complete. However, in order for the ILIT to become operative and for the gift, estate and generation skipping transfer tax benefits of the creation of an ILIT to be realized, there are many steps which the grantor and/or the trustee will need to take. It is important that the grantor and the trustee be advised by their attorney of what needs to be accomplished so their goals can be met.

## Funding the Trust

### A. Opening a Bank Account

The trustee of a life insurance trust may wish to open a trust account with a local bank. Whether or not the trustee will wish to open the bank account *ab initio* will depend, in part, upon whether the premiums on any life insurance policy held by the trust will be paid directly by the insured or the insured's employer, or will be paid by means of contributions by the insured to the trust. If premiums are paid directly by the insured or the insured's employer and the trust does not anticipate making any current disbursements (e.g., for trustee's commissions or legal expenses), the trustee need not open a bank account until additional funds are added to the trust by the grantor or the proceeds of a life insurance policy become payable to the trust. However, the trustee will wish to open a bank account for the trust if: (1) the insured will make contributions to the trust and the trustee will pay the premiums directly, (2) additional assets (other than life insurance policies) will be added to the trust, or (3) the trust will be expected to make disbursements.

### B. Obtaining an Employer Identification Number

Although not entirely clear, it appears that, if a trust qualifies as a grantor trust for income tax purposes under Internal Revenue Code §§ 671–677 (I.R.C.), it is not necessary for the trustee to apply for and obtain an employer identification number for the trust.[1] An employer identification number will not be necessary because all of the income, credits and deductions of the trust will be attributed to the grantor. However, life insurance companies, in connection with an application for an insurance policy or in connection with the assignment of an insurance policy, frequently will require an employer identification number for the trust. In addition, if the life insurance trust does not qualify as a grantor trust or the income is taxable in part to other individuals besides the grantor, which may be the case if beneficiaries have *Crummey* withdrawal powers, it will be necessary to obtain an employer identification number. An employer identification number may be obtained by filing an Application For Employer Identification Number (Form SS-4) with the Internal Revenue Service (the "IRS" or "Service").

### C. Purchase or Assignment of Life Insurance Policy

Once the trust agreement is executed by the grantor and the trustee, it will be necessary for the trustee to purchase a life insurance policy on the life of the insured or for the insured to assign to the trust a life insurance policy he or she already owns. If the trustee will purchase a life insurance policy, the trustee will have to complete an application for the insurance with the life insurance company and arrange for the insured to have the necessary medical examinations. It is very important in completing the application that the trustee, rather than the insured, is designated as both the owner and beneficiary of the life insurance policy. This is in order to avoid the application of the three-year rule which could cause inclusion of the policy in the insured's estate.[2]

If the insured already owns the life insurance policy, the insured will have to assign the life insurance policy to the trust. The insured should review the policy to determine whether there are any restrictions on assignment and review the requirements set forth in the life insurance policy or established by the life insurance company to effect the assignment. At a minimum, the insured will probably be required to complete a change of beneficiary/owner form and file it with the life insurance company. It is critical that the insured complete all steps necessary for an effective assignment of the policy. The failure to effectively assign a life insurance policy may have adverse federal and state estate and inheritance tax consequences as well as adverse state law consequences.

### D. Premium Payments

It is critical that the premium payments on life insurance be paid promptly when due. Failure to make the premium payments could result in the policy lapsing. It is thus important for the trustee and the grantor to discuss in advance of the trust's creation who has the responsibility for paying the premiums and then to make sure that the life insurance company is on notice so that the schedule for premium payments is sent directly to the appropriate person.

## Securing the Gift Tax Advantages Through the Use of *Crummey* Powers

### A. Gift Tax Concerns

Transfers to an *inter vivos* irrevocable trust (over which the grantor does not retain the right to designate new beneficiaries, change absolutely the interests of the beneficiaries, or any other power which would render the gift incomplete) are completed gifts. This includes the transfer of a life insurance policy and the payment of premiums on such policy, directly or indirectly. Accordingly, a primary consideration in creating an ILIT is how to avoid incurring gift tax on: (1) the transfer of the life insurance policy to the trust; and (2) the payment of the policy premiums directly by a transfer of cash to the trust or the payment of the premiums by the grantor's employer (or a third party).[3]

Thus, securing the gift tax annual exclusion for contributions made by the grantor to the trust becomes of critical concern after execution of an ILIT.[4] If the grantor is able to make transfers to the trust within the gift tax annual exclusion amount, the grantor—through an irrevocable trust—can transfer significant assets without the imposition of a gift tax.

When a grantor transfers a life insurance policy to an ILIT, the grantor has made a transfer which is subject to the gift tax—unless it qualifies for the annual exclusion under I.R.C. § 2503(b). Although an outright gift of an insurance policy is a gift of a "present interest" eligible for the annual exclusion, when a policy is transferred to an ILIT, the trust terms determine whether the transfer qualifies as a transfer of a present interest.[5]

Direct or indirect contributions for premium payments to an ILIT are also completed gifts. Thus, to avoid incurring a gift tax, it is important to secure the gift tax annual exclusion for the payment of policy premiums directly by the grantor—or by the grantor's employer in the case of group term or other employer-paid insurance—and for contributions to an ILIT by the grantor of the funds necessary to pay the premiums on the policy held by the trust. The trust terms determine whether such premium payments are gifts of present interests qualifying for the section 2503(b) annual exclusion. For example, if the trust provides that the trust terminates at the grantor's death, the premium payments by the grantor are gifts of a present interest and, thus, qualify for the gift tax annual exclusion.[6] However, if the trust will continue after the grantor's death, the gifts of the premiums are gifts of a future interest.[7] Through the use of *Crummey* withdrawal powers, transfers to an irrevocable life insurance trust which will continue after the grantor's death may qualify for the annual exclusion.

### B. *Crummey* Powers

To ensure that cash gifts to a trust for the payment of future life insurance premiums—or for the actual payment of premiums by the insured or the insured's employer which are treated as contributions to a trust—qualify for the I.R.C. § 2503(b) gift tax annual exclusion, the most common drafting technique is to give one or more beneficiaries the right to withdraw amounts contributed to the trust for a specified period of time after contributed.[8] This unrestricted right to the immediate use, possession, and enjoyment of the contribution to the trust, whether or not exercised, makes the transfer one of a present interest which qualifies for the annual exclusion under section 2503(b).[9] Such a right is known as a "*Crummey*" power.[10]

To qualify a transfer to a trust for the section 2503(b) gift tax annual exclusion, the IRS requires that a beneficiary be given prompt notice of his or her right of withdrawal and a reasonable opportunity to exercise such power before it lapses.[11]

### 1. Notice

The IRS takes the position that each beneficiary must receive notice of his or her right to withdraw property from the trust or the power to withdraw will be regarded as "illusory" and no gift tax annual exclusion with respect to the transfer to the trust will be allowed.[12] The IRS requires that each beneficiary be notified not only of his or her right of withdrawal but also of the amount of the contribution and the amount of the withdrawal right.[13] In order for the beneficiary to have a "present" interest in the property, this notice must be given immediately after the addition to the trust is made.[14] The notification should be in writing and should contain:

(i) a description of the property transferred to the trust;

(ii) the respective rights of withdrawal in the beneficiary resulting from the transfer; and

(iii) the period of time in which the beneficiary has a right to exercise his or her power of withdrawal.

Although in the notice the trustee may compute the amount subject to each beneficiary's withdrawal power, it may be sufficient for the trustee to send the beneficiary a copy of the trust, direct the beneficiary's attention to the specific provision of the trust agreement providing for the withdrawal power, and advise the beneficiary of the amount and date of a contribution. As a result, the beneficiary may compute his or her own withdrawal power and choose whether to exercise it. This approach shifts the responsibility for an error in calculation to the beneficiary and does not place it on the trustee which, in some cases, might have the effect of limiting the amount of the gift tax annual exclusion.

As discussed below, notification should be given to each beneficiary even if such beneficiary has waived his or her rights to notification.

In light of the IRS's position in TAM 9532001 where the IRS requires *current* notice to a beneficiary of any contribution to a trust over which the beneficiary has a power of withdrawal, it is advisable to send the notice certified mail/return receipt requested so there is proof that notice was received by the beneficiary.

**2. Waiver**

Even though the trustee will give annual notice of contributions to an ILIT, if a trust instrument allows a beneficiary (or a guardian on behalf of a minor during the period of a beneficiary's minority) to waive his or her right to receive notice of a withdrawal right, such a waiver should also be executed by each holder of a withdrawal power. It is advisable to have each beneficiary waive notification rights so that a position may be taken that the beneficiary did have notice initially of his or her withdrawal rights in the event the trustee in a given year fails to give current notice of such rights.

It should be noted, however, that in TAM 9532001, the IRS has taken the position that a waiver by a holder of a power of withdrawal of the right to receive notification prevents the holder of the power of withdrawal from having the immediate use, possession and enjoyment of the property (that is, a present interest in the property) and, therefore, the transfer does not qualify for the gift tax annual exclusion. The IRS concludes that a donee must have current notice of any gift in order for that gift to be a transfer of a present interest which qualifies for the gift tax annual exclusion.

The position taken by the IRS in this ruling appears to be flawed for several reasons. First, in Revenue Ruling 81-7, *supra*, (which is the public ruling in which the IRS addresses the notification requirement for a power of withdrawal to qualify as a transfer of a "present interest"), the IRS only requires that the holder of a power of withdrawal be given "a reasonable opportunity to learn of and to exercise the demand right before it lapsed" so that the demand right would not be "illusory" and effectively deprive the holder of a power of withdrawal of the power. There is no requirement in Revenue Ruling 81-7 that there be "current notice" of any gift to the trust.

Moreover, *Fondren v. Comr.*,[15] to which the IRS cites in this TAM, does not support the IRS's conclusion that a waiver of notification prevents a holder of a power of withdrawal from having a present interest. The issue addressed by the Court in *Fondren* was whether beneficiaries of a discretionary trust have a present interest in the trust. Moreover, in describing the rights that a beneficiary must have in order to have a "present interest," the Supreme Court in *Fondren* stated that the donee must have the right presently to use, possess or enjoy the property. When a waiver is executed by a holder of power of withdrawal, these rights are in no way compromised.

Similarly, *Crummey v. Comr.*, *supra.,* also cited by the IRS, does not support the IRS's contention that current notice is required. In *Crummey*, the Ninth Circuit held that a gift of property in trust for a minor child is a gift of a present interest in property where the child has a right to demand that the trustee distribute the property to him or her. The court did not impose any requirement of notification. In fact, in *Crummey*, the court specifically noted that, as a practical matter, some (if not all) of the beneficiaries did not even know that they had any right to demand funds from the trust, and they probably did not know when contributions were made to the trust or in what amounts. Nonetheless, the court concluded that all that is required to qualify a transfer as a gift of a present interest is that the beneficiary has the right to demand the property transferred. The exercise of a waiver does not in any way restrict a beneficiary's right to demand the property be distributed to him.

What should such a waiver contain? Such a waiver should include a statement by the beneficiary exhibiting knowledge of his or her withdrawal rights and right to receive notification, acknowledging the expected annual contributions to the trust, waiving right to notification of any additions to the trust (including the initial contribution, if applicable), and reserving the right to require the trustee to give notifi-

cation in the future on demand. If a waiver of the right to notification is made on behalf of an individual under a legal disability, it is advisable to have the waiver only apply while the beneficiary is under the legal disability.

### 3. Reasonable Opportunity to Exercise

The holder of a power of withdrawal must also have a reasonable opportunity to exercise the withdrawal power which means that a trustee must give prompt notice of a withdrawal right especially where the withdrawal period is limited. In private letter rulings, the IRS has indicated that 30 days constitutes a reasonable time between notice of the withdrawal right and its lapse.[16] The tax court in *Cristafani Est. v. Comr*,[17] suggested that a 15-day unrestricted demand right was reasonable. A period of three days, however, does not constitute a reasonable time period.[18] Moreover, when the holders of *Crummey* withdrawal powers are minors, some rulings suggest that the period between notice and lapse of the withdrawal right should be sufficient to permit the appointment of a guardian under state law.[19]

### 4. Excluding Beneficiaries from Having Powers of Withdrawal

If the grantor has already made an annual exclusion gift to a holder of a power of withdrawal in a particular year, if the trust instrument so authorizes, that beneficiary should be excluded from having a power of withdrawal in that year.[20] The following form may be used to exclude a holder of a power of withdrawal:

"WHEREAS, on ____________, an Agreement of Trust (the "Trust") was entered into between ___________________, as Grantor, and ___________________, as Trustee; and

WHEREAS, pursuant to paragraph ____ of Article ________ of the Trust, ____________ has the power to withdraw property transferred to the Trust; and

WHEREAS, paragraph ____ of Article ________ of the Trust provides, in part, as follows:

'C. Prior to the transfer of any property to the trust, the Trustee may exclude any one or more persons from having powers of withdrawal over that transfer and/or subsequent transfers, by delivering an instrument in writing to such holder of a power of withdrawal'; and

WHEREAS, in accordance with paragraph ____ of Article ________, ___________, as Trustee, desires to exercise this power to exclude _______________, from having a power of withdrawal over property to be transferred to the Trust by the Grantor during the calendar year ending December 31, _____.

NOW, THEREFORE, in accordance with paragraph ____ of Article ________, ____________, as Trustee, hereby excludes from having a power of withdrawal over property to be transferred to the Trust by the Grantor during the calendar year ending December 31, ______.

IN WITNESS WHEREOF, _______________ has hereunto set his/her hand and seal this day of

__________________________________

____________, Trustee"

### 5. Special Concerns Where Minors Are Powerholders

A *Crummey* withdrawal power qualifies an addition to a trust as a gift of a present interest in property—even though the beneficiary with the right is a minor—so long as there is no impediment under the trust instrument or local law to the appointment of a guardian who could exercise the power and the minor donee has a right to demand distribution.[21] The notice of the withdrawal right should be given, if the beneficiary is a minor, to the court-appointed guardian, or, if none has been appointed, to a parent as the "natural guardian."[22] If the trustee is a parent of the minor beneficiary, the further issue arises as to whether the trustee needs formally to notify himself or herself. Two rulings suggest that this is not necessary because "actual knowledge is sufficient."[23]

### 6. Special Concerns When Trust Asset Is an Employer Group-Term Policy

Group-term policies also present special problems in satisfying withdrawal rights and notice requirements. First, when contributions are made to a trust on a regular schedule to pay insurance premiums, the IRS has taken the position that the trustee is authorized to make a single delivery of the future premium schedule to meet the notice requirement.[24] An annual notification of regular premium payments also appears to satisfy the notice requirement. In TAM 9045002, for example, the IRS ruled that gifts to a trust qualified for the annual exclusion where the trust instrument provided that in the event of recurring contributions, such as quarterly or monthly premium payments on life insurance on the grantor's life, the trustee could send just one notice each year, at the beginning of the year, notifying each person of the future premium dates and of the 60-day right of withdrawal following each such premium payment. It is unclear what effect TAM 9532001 (which requires current notice of any gift to a trust over which a beneficiary has a power of withdrawal in order to be eligible for the gift tax annual exclusion) has on these prior rulings. A prospective annual notice should not be considered a waiver of a right to notification so long

as that notice clearly describes the dates on which the future premium payments will be made (or contributions will be made to the trust to make such premium payments), describes the beneficiary's power of withdrawal and quantifies the amount of his or her withdrawal right. However, for group-term insurance, a future premium schedule is not the solution to the "adequate notice" requirement, because the trustee may not know when the employer actually paid the premiums.

If the trust corpus consists solely of a group-term life insurance policy, the withdrawal right will be over the policy itself. Because the employer pays the premiums directly, there are no cash additions to the trust. This raises the issue of whether, in order to "cover" the withdrawal right, it is necessary for the grantor to contribute cash to the trust (e.g., the "liquidity seed"). There are IRS rulings suggesting that the annual exclusion may be permitted if the corpus consists only of the group policy itself and, thus, only the policy could be withdrawn.[25]

### 7. Need for Liquidity Seed

When beneficiaries have *Crummey* powers, one issue that arises is whether the trustee is required to retain cash contributed to the trust for the payment of premiums until the *Crummey* withdrawal powers expire before paying the premiums. In other words, does the right to withdraw a life insurance policy meet the "present interest" requirement to qualify an addition to the trust (which has been used to pay the premium on the insurance) for the I.R.C. § 2503(b) gift tax annual exclusion since the economic benefits of a life insurance policy may not be received until the future?

The IRS has issued private rulings in which the employer's payment of premiums on a group-life insurance policy assigned to a trust qualifies for the gift tax annual exclusion when the trust beneficiaries have withdrawal powers.[26] In such a case, cash never passes "through" the trust over which the beneficiary may exercise the withdrawal power. The result in these rulings appears to be founded on Regs. § 25.2503-3(c), Example 6, which provides:

> L pays premium on a policy of insurance on his life. All the incidents of ownership in the policy (including the right to surrender the policy) are vested in M. The payment of premiums by L constitutes a gift of a present interest in property.[27]

Accordingly, it appears from this regulation that the IRS takes the position that if a third party pays premiums directly to the insurance company on life insurance owned by an individual, the third party has made a gift of a present interest to that individual, even though the benefits which the third party provides by assisting and maintaining the policy may not be derived by the policy owner until the future (i.e., the death of the insured). The rationale of this regulation and the referenced PLRs should also apply to convey a "present interest" on the holder of a withdrawal power when the only asset that may be withdrawn is a life insurance policy owned by the trust.[28]

On the basis of the foregoing regulation and PLRs, when beneficiaries may withdraw the life insurance policy itself, the trustee should not feel compelled to retain cash contributed to a trust until the beneficiaries' withdrawal powers have lapsed. Indeed, where "hanging" powers are used, the power may not expire for years, meaning that the use of the cash contributed to the trust over which beneficiaries have withdrawal powers to pay premiums would be impossible if the trustees feel compelled to keep the cash from being used to pay the premiums until the power expires.

Another issue arises, however, when the beneficiaries do not have the authority to withdraw the policy itself. To qualify transfers to the trust for the section 2503(b) gift tax annual exclusion in such circumstances, the trustee should not pay the premiums until the withdrawal powers have lapsed and a "liquidity seed" may be necessary.[29]

## C. Minimizing Gift Tax Exposure Where Annual Exclusions Do Not Cover Contributions

### 1. Loan from Grantor

As an alternative to making a contribution to an ILIT to provide the funds necessary to pay the premiums on any life insurance policy owned by the trust, it may be possible for the grantor to loan the funds to the trust. The grantor could loan on an annual basis to the trust such amount as is necessary to allow the trustees to pay the premium payments on the life insurance policies owned by the trust.

In order to avoid the loan of the funds to the trust from being treated as a gift, it is important to formalize the loan relationship. Where a loan relationship is not formalized and the facts and circumstances do not show that the transfer was made with a real expectation of repayment, the loan may be recharacterized as a gift. For example, in *Miller v. Comr.*, T.C. Memo 1996-3, the Tax Court stated that in order to determine whether a transfer was a loan (rather than a gift) made with a real expectation of repayment and intention to enforce the debt depended on all the facts and circumstances including whether (1) there was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a

demand for payment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected that the transaction was a loan, and (9) the manner in which the transaction was reported for federal tax purposes was consistent with a loan.[30]

In addition, in order to avoid the loan to the trust having a gift element, the loan must be interest bearing. Under I.R.C. § 7872, any loan which bears a below-market interest rate and is a gift loan may have adverse tax consequences to the lender. The foregone interest is treated as transferred from the lender to the borrower, and then retransferred by the borrower to the lender as interest. Thus, the foregone interest is treated as a gift by the lender to the borrower and then is treated as income to the lender from the borrower. Under section 7872(c) the term "below-market" is defined as any loan, in the case of demand loan, where interest is payable on the loan at a rate less than the applicable federal rate or, in the case of a term loan, where the amount of the loan exceeds the present value of all payments due under the loan. For demand loans, section 7872(f) provides that the applicable federal rate is the federal short-term rate under I.R.C. § 1274(d) for the period for the which the amount of foregone interest is being determined, compounded semi-annually. In the case of a term loan, to determine whether the amount of the loan exceeds the present value of all payments due under the loan, the applicable federal rate used is the applicable federal rate in effect under section 1274(d) (as of the day of which the loan was made) compounded semi-annually—that is, the federal short-term rate if the loan is for a term of not over three years, the federal mid-term rate if the loan is over three years but not over nine years, and the federal long-term rate if the term is over nine years.

Thus, in order to avoid there being a gift or income element of a loan between the grantor of an *inter vivos* irrevocable trust and the trust, in the case of a demand loan, the interest needs to be payable at the federal short-term rate in effect under section 1274(d) for the period for which the amount of foregone interest is being determined, compounded semi-annually; and, in the case of a term loan, the interest must be payable at the applicable federal rate in effect under section 1274(d) (as the day on which the loan was made), compounded semi-annually. By having the interest payable in accordance with the provisions of section 7872, similarly no additional interest should be inputted as having been transferred from the borrower to the lender.

The loaning of funds by the grantor to the ILIT also raises the issue of whether there may be adverse estate tax consequences as a result of such loan. In PLR 9809032, the IRS addressed the issue of whether amounts loaned by the decedent to an *inter vivos* irrevocable trust to pay premiums would cause the trust to be includable in the decedent's estate under I.R.C. §§ 2036 and 2042. In PLR 9809032, the decedent had created an irrevocable trust naming an individual and a corporation as trustees of that trust. During the decedent's life, the trustees borrowed from the decedent amounts which were documented with promissory notes. The amounts borrowed were used to pay premiums on insurance policies owned by the trust and, at the decedent's death, five of the notes were outstanding. The terms of the notes were substantially identical except for the amount borrowed and the interest rate prevailing at the time each note was executed. The IRS ruled that the decedent did not possess any incidents of ownership in the policy under section 2042(2) as a result of the loan by the decedent of the amounts necessary for payment of the life insurance premiums. The extension of credit between the decedent and the trust was not an incident of ownership. Therefore, the Service concluded that the insurance policies would not be includable in the decedent's estate.

In addition, the Service concluded that the decedent did not retain any interest in the trust under section 2036(a)(2) as a result of the provision in the trust agreement that allowed the decedent to determine the trustee's compensation. The trust agreement provided that, during the decedent's life, the trustees would receive compensation for their services as fiduciaries as determined by the decedent. The Service concluded that this power merely provided the decedent with the ability to encourage the trustees to resign by controlling the compensation that was to be paid to the trustees. The Service noted that the decedent did not have the power to appoint a successor trustee. Thus, the power to determine compensation did not effect the beneficial enjoyment of the trust property in such a way that would make it includable in the decedent's gross estate under section 2036(a)(2). The Service, however, did not address the issue of whether the extension of credit between the decedent and the trust would be viewed in any way as a retention of the right to receive income from the trust, causing the trust to be includable under section 2036(a).

Because an ILIT which holds life insurance on the grantor's life is usually treated as a grantor trust for income tax purposes (e.g., a trust all the income, deductions and credits of which are attributed to the grantor), the payment of the interest on the funds borrowed by the trust from the grantor should not result in any taxable income to the grantor during the grantor's life. However, after the grantor's death, the trust will cease to be treated as a grantor trust for

income tax purposes. Accordingly, any payment of interest by the trust to the grantor's estate in connection with repayment of the loans will result in taxable income to the grantor's estate.

### 2. Borrowing Against the Policy

Often, an ILIT will be funded with a life insurance policy on the grantor's life which has been in force for a period of time and has accumulated cash value. As will be discussed in greater detail below, the value for gift tax purposes of the policy will be its "interpolated terminal reserve amount" (e.g., the cash surrender value of the policy) *plus* the proportionate part of the gross premium last paid before the date of the sale and *less* any outstanding loans. If this amount exceeds the amount of annual exclusions available to the grantor, the grantor may be required to use up part of his or her applicable exclusion amount (currently, $1 million) or pay gift tax in order to transfer the policy to the trust. In order to reduce the value of the life insurance policy for gift tax purposes, the grantor may wish to borrow against the cash value of the policy. This may have the effect of eliminating any potential gift tax exposure (assuming that future contributions to the ILIT to pay the premiums on the policy and to repay the loan, including interest, could be protected from gift tax by the gift tax annual exclusion or unified credit) or, at a minimum, deferring the time at which gift tax must be paid. As to the amount of the loan to be taken out, there may be restrictions under the policy as to the percentage of the cash value which the owner may borrow and the amount of the loan should not exceed the grantor's basis in the policy as this may cause the grantor adverse income tax consequences.

### D. Filing a Gift Tax Return

If the contributions to the trust exceed the amount eligible for the section 2503(b) gift tax annual exclusion (e.g., $11,000) or if the grantor wants to split a gift made to the trust with his or her spouse, the grantor must timely file a United States Gift (and GST) Tax Return (Form 709). In connection with preparing the United States Gift (and GST) Tax Return, the value of the gift will need to be determined. The value of a gift equals its fair market value. The fair market value of a gift of life insurance depends on the type of policy. The general rule is that the value of a gift of life insurance is deemed to be equal to the cost of replacing the policy on the date of the gift.[31] Regs. § 25.2512-6(a) provides:

> The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.

For example, a grantor, who owns a life insurance policy on which no further payments are to be made to the company (e.g., a single premium policy or paid-up policy) makes a gift of the contract to an irrevocable trust. The value of the gift is the amount which the company would charge for a single premium contract of the same specified amount on the life of a person of D's age.[32]

However, if a life insurance policy has been in existence for some time and future premiums are yet to be paid, the value of the gift is approximately equal to the total of: (1) at the date of the gift the interpolated terminal reserve (usually roughly equivalent to cash value); and (2) the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date.[33]

This method may not be used, however, if, because of the "unusual nature of the contract," the approximation is not reasonably close to full value.[34] Thus, for example, the interpolated terminal reserve value at the date of the gift will not be deemed to reflect the value of the gift if a condition of the insured's health makes the insured uninsurable at the time of the gift.[35]

The value of a gift of a term life insurance policy, however, is unclear for gift tax purposes. Arguably, its value will equal the value of the pro rata portion of the premium for the unexpired portion of the term.

However, with respect to the payment of a premium on group-term insurance assigned by an employee to a trust, the amount of the gift which will be deemed to be made is measured by the imputed income amount under Regs. § 1.79-3(d)(2).

## The GSTT Question: To Allocate or Not to Allocate

Transfers to an ILIT may not only raise gift tax concerns, but they may also have generation-skipping transfer tax ("GST tax") implications. The GST tax will be of concern where potential beneficiaries of an ILIT are skip persons—that is, persons who are assigned to a generation which is two or more generations below that of the transferor (e.g., a grandchild, great niece or great nephew).[36] A GST tax is imposed where there is a "direct skip" (e.g., a transfer subject to gift or estate tax to a skip person), a taxable distribution (e.g., any distribution from a trust to a skip person) or a taxable termination (e.g., the termination of an interest in property held in trust unless after the termination (i) a non-skip person has an interest in such property or (ii) a distribution from the trust may not be made to a skip person).[37] If a transfer to an ILIT or a distribution from an ILIT may result in a taxable distribution or taxable termination, an analysis should be completed to determine whether the non-taxable gift exclusion applies or the transferor's GST exemption should be allocated.

### A. Non-Taxable Gift Exclusion

Each individual may transfer free of gift tax $11,000 (as increased by the cost-of-living adjustment) to any individual. This is known as the "annual exclusion." Such annual exclusion gifts to skip persons are also exempt from the GST tax except as to certain transfers in trust.

Where an annual exclusion gift is made in trust, the non-taxable gift exclusion from the GST tax is not available unless the trust satisfies certain requirements. I.R.C. § 2642(c)(2) provides that the nontaxable gift exclusion does not apply to any transfer to a trust for the benefit of an individual unless, first, the transfer is a "direct skip" as required by section 2642(c)(1). A direct skip involves a transfer to a "skip person."[38] Regs. § 26.2612-1(d)(2) provides that a trust will be treated as a "skip person" if (i) all interests in the trust are held by skip persons or (2) no person holds an interest in the trust and no distributions, other than a distribution the probability of which occurring is so remote as to be negligible, may be made after the transfer to a person other than a skip person.

Second, section 2642(c)(2) provides that, in order for the nontaxable gift exclusion to apply to a transfer in trust, the trust must provide that during the life of the individual no portion of the corpus or the income of the trust may be distributed to or for the benefit of any person other than the skip person and, if the skip person dies before the trust is terminated, the assets of the trust will be includable in the skip person's gross estate (e.g., the skip person has a general power of appointment). That means, of course, that no one other than one skip person beneficiary (e.g., one grandchild) may be a beneficiary of the trust.

Therefore, as a general rule, transfers to a traditional ILIT, where discretionary beneficiaries include not just one of the transferor's grandchildren but the transferor's spouse, children and other grandchildren will not be protected from GST taxation by reason of the nontaxable gift exclusion. The transfers to such trusts do not constitute "direct skips" because the spouse and children are not skip persons. The transfers to the trust will not receive the protection afforded under section 2642(c)(1) or (2). Thus, if property attributable to such transfers is distributed to skip persons (e.g., the transferor's grandchildren), a taxable distribution or taxable termination will occur and a GST tax will be imposed, assuming that the transferor's GST exemption has not been allocated to the trust and that the transfer does not qualify for the educational or medical exclusion.

If the primary reason for the creation of the trust is to benefit the transferor's grandchildren (and, perhaps, more remote descendants), a transferor may be able to take advantage of the non-taxable gift exclusion if the trust provisions comply with the provisions of I.R.C. § 2642(c)(2) as described above. However, under the regulations, it is critical that the trust be drafted as a skip person (and, thus, there must be no interests, including contingent interests, in non-skip persons) and each trust must have only one skip person as a beneficiary. A trust agreement may be drafted which provides for the creation of a subtrust for each skip person the grantor wishes to benefit, with each subtrust satisfying the requirements of section 2642(c)(2).

Granting skip persons in a trust *Crummey* powers of withdrawal over contributions to the trust will not entitle a transferor to the nontaxable gift exclusion. Regs. § 26.2652-1(a)(5), Example 5 provides that a transfer to a trust subject to a beneficiary's right of withdrawal is treated as a transfer to the trust rather than a transfer to the beneficiary.[39]

### B. GST Exemption

Because the non-taxable gift exclusion is not available for most transfers to ILITs, the generation-skipping transfer tax exemption ("GST exemption") becomes of greater importance where skip persons (e.g., grandchildren or more remote descendants) are the intended beneficiaries of the ILIT. The GST exemption is the amount of $1,100,000 in 2002 and continues to increase annually by a cost-of-living adjustment.[40] As of 2004, the GST exemption will equal the estate tax applicable exclusion amount as follows:

| Calendar Year | GST Exemption |
|---|---|
| 2004 | $1.5 million |
| 2005 | $1.5 million |
| 2006 | $2.0 million |
| 2007 | $2.0 million |
| 2008 | $2.0 million |
| 2009 | $3.5 million |

A transferor's GST exemption may be used either during lifetime or at death.

### 1. Allocation Rules—Direct Skip Transfers

Any ***direct skip transfer*** (e.g., such as a transfer of cash or other assets to a trust all the current beneficiaries of which are skip persons) during the transferor's life automatically has GST exemption allocated to it unless the transferor affirmatively elects out of the automatic allocation.[41] As a general rule, if an election out is not made, the automatic allocation of GST exemption becomes irrevocable after the due date for reporting the transfer if it were a taxable gift, including any extensions actually granted. The regulations state that an election out of the automatic allocation rule must be made by the due date (including extensions) for the filing of the gift tax return for the taxable year in which the transfer is made.[42] Once an election out has been made, the regulations indicate that the election is irrevocable.[43] The election out of the automatic allocation must be made on a timely-filed gift tax return. A gift tax return is timely filed if it is filed on or before the date that would be the date for reporting the transfer if it were a taxable gift, including any extensions actually granted.[44]

For example, a transferor transfers $10,000 to an irrevocable life insurance trust solely for the benefit of multiple skip persons (a direct skip) on July 15, 2001. The GST exemption will automatically be allocated as of April 15, 2002 (assuming no extensions are granted) unless the transferor elects out by such date. This will be the case whether or not the transfer qualifies for the gift tax annual exclusion.

### 2. Allocation Rules—Indirect Skip Transfers

In addition, a transferor's GST exemption will automatically be allocated to an ***indirect skip***. I.R.C. § 2632(c)(1) provides that if a transferor makes an indirect skip during the transferor's lifetime, the transferor's unused GST exemption will be allocated to the property to the extent necessary to make the inclusion ratio of such property zero (or, if the amount of the indirect skip exceeds the transferor's unused GST exemption, the entire unused GST exemption will be allocated to the property transferred).

An *indirect skip* is defined in section 2632(c)(3)(A) to include a transfer of property subject to gift or estate tax to a *GST trust*. The term *GST trust* is defined to include any trust that could have a generation-skipping transfer unless:

1. Twenty-five percent (25%) of the trust corpus must be distributed to or may be withdrawn by non-skip person(s): (a) before the non-skip person attains age 46, (b) on or before one or more dates that will occur before the non-skip person attains age 46, or (c) upon the occurrence of an event which may reasonably be expected to occur before the non-skip person attains age 46;

2. Twenty-five percent (25%) of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons *and* who are living on the death of an identified person who is more than 10 years older than such non-skip persons;

3. If non-skip person(s) die on or before a date or event set forth in paragraphs 1 or 2 above, more than twenty-five percent (25%) of the trust corpus must be distributed to the estate(s) of such non-skip person(s) or is subject to a general power of appointment held by such non-skip person(s);

4. The trust is includable in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;

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

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

For purposes of applying the above exceptions, section 2632(c)(3)(B) provides that the value of the transferred property is not deemed to be considered includable in the gross estate of a non-skip person or subject to a right of withdrawal if such person is holding a right to withdraw the annual exclusion amount under I.R.C. § 2503(b) and it is assumed that powers of appointment held by non-skip persons will not be exercised.

As will be discussed in further detail below, if the transferor's GST exemption has not been effectively allocated because an estate tax inclusion period exists under I.R.C. § 2642(f) and an indirect skip has occurred, the indirect skip shall be deemed to have been made only at the close of the estate tax inclusion period and the fair market value of the transfer for purposes of the allocation of the GST exemption is the

fair market value of the trust property at the close of such estate tax inclusion period.

Section 2632(c)(5) of the I.R.C. allows a transferor to elect out of these automatic allocation rules for indirect skips. An individual may elect to have the automatic allocation rules not apply to (1) an indirect skip, or (2) any and all transfers made by such transferor to a particular trust. In addition, an individual may elect to treat any trust as a GST trust for purposes of section 2632(c) with respect to any and all transfers made by such transferor to such trust and, therefore, have GST exemption automatically allocated to any such trust. These elections are deemed to be timely if made on a timely filed gift tax return for the calendar year in which a transfer was made or deemed to have been made.

These automatic allocation rules for indirect skips apply to any transfer subject to gift or estate tax made after December 31, 2000, and to an estate tax inclusion period ending after December 31, 2000.

The amount of GST exemption allocated where there is a direct or indirect skip is based on the value of the property as of the date of transfer.

### 3. Allocation Rules—Other Transfers

When the transfer is not a direct or indirect skip, an individual's GST exemption is not automatically allocated but may be allocated any time on or before the date for the filing of the transferor's estate tax return either on the transferor's gift tax or estate tax return.[45] If the allocation is made on a timely filed return, including extensions, the allocation is effective as of the date of the transfer and, therefore, the amount of GST exemption to be allocated is based on the value of property transferred as of the date of the transfer; if the allocation is made on a late-filed gift tax return, it is effective as of the date of its postmark.[46] Once made, an allocation of GST exemption on a timely return may be modified or revoked up to the due date of the return.[47] An allocation made on a late filed return is irrevocable.[48]

The regulations, however, create a special valuation rule for late allocations during life. If a transferor makes a late allocation of GST exemption to a trust, the transferor may, solely for purposes of determining the fair market value of the trust assets, elect to treat the allocation as having been made on the first day of the month during which the late allocation is made—such first day of the month to be known as the "valuation date."[49] Such an allocation becomes effective when filed with the IRS and is made by stating on the gift tax return on which the allocation is made that the election is being made, the applicable valuation date and the fair market value of the trust assets on the valuation date. This rule was enacted to recognize the practical difficulties of filing an allocation on the same day the property is valued.

For example, in 2001, a transferor transferred $500,000 of cash to a discretionary trust for his children and grandchildren. No other gifts were made to the trust. Although the transferor filed a timely gift tax return, the transferor's GST exemption was not allocated to the transfer. In September 2003, the transferor decides to allocate GST exemption to the trust. The trust assets are invested in equities that vary in value substantially from day to day. Although on September 1, 2003, the transferor was able to ascertain that the value of the trust assets was $745,000, it was unclear on September 20, 2003, the date by which the return had been prepared and was going to be filed, what the value of the trust assets were since that value is ascertained by determining the mean between the highest and lowest selling prices on that date. To avoid this problem under the late allocation election, the transferor may elect to use the September 1, 2003 value of the trust assets for purposes of the late allocation of GST exemption.

This election, however, is not effective with respect to life insurance or a trust holding a life insurance policy if the insured individual has died. Presumably, this is to prevent a late allocation in the month in which the transferor dies thereby requiring any such late allocation to cover the entire proceeds of the policy. Nevertheless, this special rule appears to apply whether or not the transferor has died.

### 4. Effectiveness of Allocation

In order for any allocation of GST exemption to be effective, the allocation must clearly (1) identify the trust to which the allocation is being made, (2) the amount of GST exemption allocated to it, and (3) the value of the trust principal at the time of the allocation. The allocation must also state the "inclusion ratio" of the trust after the allocation. The "inclusion ratio" defined in I.R.C. § 2642 and explained in Regs. § 26.2642-1, basically determines the percentage of any distribution out of the trust to a skip person which is subject to GST tax. For example, if the inclusion ratio is 60 percent, 60 percent of each distribution to a skip person, in effect, is subject to GST tax. More specifically, this inclusion ratio determines the effective rate of GST tax (called the "applicable rate").

Any such allocation of GST exemption is void to the extent the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust.

Regs. § 26.2632-1(b)(2)(i) also provides that an allocation of GST exemption is void if the allocation is

made to a trust that has no GST potential with respect to the transfer for whom the allocation is being made, as of the date of the transferor's death. For purposes of determining whether such an allocation is void, the regulations provide that a trust has GST potential even if the possibility of a generation-skipping transfer is so remote as to be negligible. This would occur, for example, where the remainder of a trust for a child will pass to charity upon the child's death. In effect and in general, this rule is beneficial as it will prevent the effective use of the GST exemption where no generation-skipping transfer tax otherwise would be imposed.

### 5. ETIP Rules

Section 2642(f) of the I.R.C. prevents any allocation of GST exemption to property transferred *inter vivos* during the period that such property would be includable in the gross estate of the transferor (other than by reason of I.R.C. § 2035) or the transferor's spouse (other than by reason of section 2035). (This period is known as the estate tax inclusion period or ETIP.) Regs. § 26.2632-1(c) provides that allocation of GST exemption is not effective during that period of time when the transferred property (i) would be includable in the estate of the transferor (other than by reason of a transfer within three years of death under section 2035) or (ii) would be includable in the estate of the spouse of the transferor (other than by reason of a transfer within three years of death under section 2035). (For purposes of applying these rules, an individual or transferor is treated as including the spouse of such individual or transferor.[50])

Regs. § 26.2632-1(c)(2)(ii)(A), however, provides that transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the transferor's spouse for purposes of the ETIP rules if the possibility that the property will be included is so remote as to be negligible. For purposes of this exception, the possibility is so remote as to be negligible of property being included in the transferor's or the transferor's spouse's gross estate if it can be ascertained by actuarial standards that there is less than a five percent probability that the property will be included in the gross estate.

Regs. § 26.2632(1)(c)(2)(ii)(B) also provides that transferred property is not considered as being subject to inclusion in the transferor's spouse's gross estate if the spouse possesses with respect to any transfer to a trust the right to withdraw no more than the greater of $5,000 or five percent of the trust corpus and such withdrawal right terminates no later than 60 days after the transfer to the trust.

The ETIP terminates on the first to occur of (a) the death of the transferor, (b) the time at which no portion of property would be includable in the transferor's gross estate (other than by reason of I.R.C. § 2035) or, in the case of an individual who is a transferor solely by reason of an election under I.R.C. § 2513 (gift splitting with a spouse), the time of which no portion would be includable in the gross estate of the individual's spouse (other than by reason of section 2035), (c) the time of a generation-skipping transfer, or (d) where the estate tax inclusion period arises by reason of an interest or power held by the transferor's spouse, at the first to occur of (1) the death of the spouse or (2) the time at which no portion of the property would be includable in the spouse's gross estate (other than by reason of section 2035).[51]

An allocation of GST exemption on a gift tax return filed by the date the return would be due, if the termination of the ETIP were a taxable gift, is effective as of the date of the termination. An allocation of GST exemption made after that date is effective as of the earlier of the date the gift tax return on which the allocation is filed or the date of death of the transferor (or the transferor's spouse, if applicable).[52] Regs. § 26.2632-1(c)(1) also provides that an allocation of GST exemption to property subject to an ETIP that is made prior to the ETIP cannot be revoked.

If the property is includable in the transferor's estate, the value to be used for purposes of allocating GST exemption under section 2642(f)(2) of the I.R.C. is the value for federal estate tax purposes. However, if the property is not includable in the transferor's gross estate, its value for purposes of determining the amount of GST exemption that must be allocated is the value of the property at the close of the ETIP or, if any allocation of GST exemption to such property is not made on a timely filed gift tax return for the calendar year in which the estate tax inclusion period ends, its value is its fair market value at the time such allocation is filed with the Secretary.[53]

An automatic allocation of GST exemption, or an allocation on a timely gift tax return, is not effective until the termination of the ETIP. The transferor can wait until the termination of the ETIP to make the allocation, when the exact amount of the property to which the GST exemption will be allocated is known. If the ETIP terminates during the transferor's life, an allocation of GST exemption may be made on a timely gift tax return for the taxable year in which the ETIP terminates, and the allocation will be effective as of the ETIP termination date.[54] If the ETIP terminates at the transferor's death, the allocation of GST exemption is made on a timely filed estate tax return and is effective as of the date of death.

## 6. ETIPs and ILITs

An ETIP may also arise in the context of a transfer to an ILIT where the transferor's spouse has an "interest" in the trust which will cause a portion of the trust to be includable in the spouse's estate. For example, under the attribution rule of I.R.C. § 2642(f)(4), the granting of a hanging *Crummey* power to the transferor's spouse creates an ETIP because the power would be includable in the spouse's estate if the spouse were to die possessing the power because the power is a general power of appointment under § 2041 and because the power is not limited to the greater of $5,000 or five percent of the trust corpus as required by the exception contained in Regs. § 26.2632-1(c)(2)(ii)(B). As a practical matter, this means that, if a transferor intends to allocate GST exemption to an ILIT and wishes transfers to it to qualify for the gift tax annual exclusion by granting the spouse a *Crummey* power of withdrawal, the spouse should be granted a power of withdrawal at any time of only the greater of $5,000 or five percent of the trust corpus, which power should lapse in full in 60 days. Other beneficiaries may receive the "standard" $11,000/$22,000 *Crummey* powers, lapsing at a rate of the greater of $5,000 or five percent of the amount subject to withdrawal, with the balance of the withdrawal rights "hanging."

## 7. Retroactive Allocation of GST Exemption to Certain Transfers

Section 2632(d) of the I.R.C. permits a transferor retroactively to allocate the transferor's GST exemption to a trust in the case where a beneficiary of the trust who is related to the transferor predeceases the transferor. Section 2632(d)(1) provides that a transferor may make an allocation of the transferor's unused GST exemption to any previous transfers (or transfers) to a trust if:

1. A non-skip person has an interest or a future interest—a person is considered to have a "future interest" in a trust if the trust may permit income or corpus to be paid to such person on a date or dates in the future—in the trust (to which the transfer has been made);

2. Such non-skip person (i) is a lineal descendant of a grandparent of the transferor or of a grandparent of the transferor's spouse (or former spouse), and (ii) is assigned to a generation below the generation assignment of the transferor; and

3. Such non-skip person predeceased the transferor.

To the extent that the transferor makes such a retroactive allocation to any previous transfer or transfer to the trust, such a retroactive allocation is to be made on a chronological basis.

If the retroactive allocation is made on a gift tax return filed on or before the date for timely filing a gift tax return within a calendar year within which the non-skip person dies, the value of such transfer or transfers for purposes of determining the amount of GST exemption to be allocated is determined as if the allocation had been made on a timely filed gift tax return for the calendar year in which each transfer was made, such allocation is effective immediately before such death, and the amount of the transferor's unused GST exemption available to be allocated is determined immediately before such non-skip person's death.

This retroactive allocation provision applies to any death of a non-skip person which occurs after December 31, 2000.

## 8. Relief Provisions

Because of the complexity of the rules for the allocation of a transferor's GST exemption, Congress recently enacted I.R.C. § 2642(g) to provide relief for late elections in certain circumstances. Section 2642(g) authorizes the Secretary to issue regulations to prescribe certain circumstances and procedures under which extensions of time will be granted to make an allocation of GST exemption described in section 2642(b)(1) or (2), and to elect out of the automatic allocation rules for direct skips under I.R.C. § 2632(b)(3) or for indirect skips under section 2632(c)(5). In determining whether to grant relief, the Secretary is directed to take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of granting this relief, the time for making the allocation or election is directed to be treated as if not expressly prescribed by statute. This relief from late elections is applicable to requests pending on, or filed after, December 31, 2000.

Section 2642(g)(2) also provides relief where there is substantial compliance with the GST provisions. This section provides that an allocation of GST exemption under section 2632 that demonstrates an intent of the lowest possible inclusion ratio with respect to a transfer or a trust will be deemed to be an allocation of so much of the transferor's unused GST exemption as to produce the lowest possible inclusion ratio. For purposes of determining substantial compliance, the Secretary is directed to take into account all relevant circumstances, including evidence of intent contained in the trust instrument or an instrument of transfer and such other factors as the Secretary deems

relevant. The relief for substantial compliance applies to transfers subject to gift or estate tax made after December 31, 2000.

### 9. To Allocate or Not to Allocate

Most ILITs are structured to provide that the proceeds will be held for the benefit of the insured's spouse for his or her life and then will be paid to the insured's children during their lifetimes (either immediately upon their parents' deaths or as the children reach certain ages after their parents' deaths). Because, as a general rule, there would not be a transfer from the trust to a skip person in these circumstances, no GST tax should be payable and no GST exemption should be allocated.

However, if a child who has descendants dies before the termination of the trust, many trusts provide that the child's portion of the proceeds become payable to skip persons (i.e., the deceased child's descendants). The GST tax consequences of such payments must be considered. Although, in some cases, grandchildren can be treated as children for purposes of the GST tax under the move-up-a-generation rule contained in I.R.C. § 2651(e), this rule has limited application. Actuarially, however, it is unlikely that children will die before their parents, so if an ILIT is structured to terminate in favor of the children, it is unlikely that the GST tax issue will have to be faced with respect to trust distributions and GST exemption should not be wasted on such a trust.

However, if grandchildren or other skip persons are potential and intended beneficiaries of the trust, it may be appropriate to allocate GST exemption to the ILIT. If skip persons are the intended beneficiaries of an ILIT, the grantor needs to determine if the allocation of GST exemption to the trust is the best use of his or her GST exemption. Will the grantor obtain the best leverage through the allocation of the GST exemption to the ILIT? Are there other assets where potential appreciation is likely to be greater than the insurance held in the trust?

### 10. When to Make the Allocation

If all transfers made by the grantor fall under the protection of the I.R.C. § 2503(b) gift tax annual exclusion, no gift tax return is due. Although this might suggest that a timely filed gift tax return can be filed at any time (even beyond April 15 of the year following the gift and even if no extension to file has been granted), the return must be timely filed (i.e., by April 15 of the year following the gift if no extensions are granted) for the amount of GST exemption to be allocated based on the value of the property for gift tax purposes.

As stated above, if the allocation is made on a timely filed gift tax return, the amount of GST exemption needed to protect the property in the trust from the generation-skipping transfer tax is equal to the gift tax value of the transfer. Generally, for the transfer of a life insurance policy, that will be the policy's cash value plus any unused (or remaining) premium already paid. For any later paid premium, the gift will equal the amount of the premium, unless a special valuation rule is prescribed. Where the premiums are paid by the trust and the grantor makes contributions to the trust, the gift will equal the fair market value of the property transferred to the trust by the grantor.

However, for a late-filed return, the amount of GST exemption required to be allocated to protect the entire trust from the GST tax equals, as a general rule, the value of the property at the time of the allocation. Although the regulations provide no specific guidance as to how a policy of insurance would be valued for purposes of a late allocation of GST exemption to it, presumably its value will be the same value as would apply for gift tax purposes if a gift of the policy were being made at that time. Whether this value will be more than the value at the time of original gift may depend, in part, upon the type of insurance.

*Example:* For a one-year term policy, the value at the time of the late allocation arguably should be nil. Thus, if the policy is acquired and the premium is paid on January 1, 2001, the policy will have no value (unless the insured has died during the coverage period) when the return is filed late (after April 15, 2002, if no extensions are granted) and the allocation is made. Because it is assumed that the insurance has expired (the insured has lived), no allocation may be necessary. On the other hand, if the insured dies during the term, a timely allocation of GST exemption should be made based upon the amount of the premium, because that timely allocation should exempt the entire policy proceeds from GST taxation. A late-filed GST exemption allocation would be much more costly in this case: if the allocation is made late, the proceeds will have been paid or be payable and, thus, the amount of GST exemption required to be allocated will equal the amount of the proceeds.

However, in most circumstances, the ILIT will not hold one-year term insurance, but will hold a policy under which premiums are payable each year for several years or for the insured's life. Hence, when a late allocation of GST exemption is made, there will be value in the trust (i.e., value at least equal to the unexpired insurance premium for the year in which the exemption is allocated).

*Example:* An irrevocable trust purchases a five-year term life insurance policy in 2001. If the alloca-

tion of GST exemption for the first year the policy is held is made on a gift tax return filed one day late (on April 16, 2002), the term premium for 2001 will have been used up (and have no value) but the premium for 2002 will have been paid and most of it will not have expired. Nonetheless, in these circumstances, the late-filed allocation will apply only to that part of the trust attributable to the 2001 contribution and not to that made in 2002. Section 2642(d) of the I.R.C. provides that where multiple contributions to a trust are made, the amount of the nontaxable portion is based upon relative values immediately before the transfer, indicating that later transfers (e.g., those made in a later year, although before the allocation is actually made on the late-filed return) are not considered. Hence, one-day late returns may be appropriate.

Additional problems arise, however, with respect to policies which have cash value. Generally, except for the first few years—when the premiums may be used to pay sales commissions and other charges—a significant portion of the annual premium may be retained in the policy as cash value. Hence, the value of one year's premium will not be reduced to zero, even by the time a late return is filed. Indeed, depending upon the type of policy and the earnings experienced "inside" the policy, it is possible that the premium will have "grown" to a larger value by the time the late-filed GST exemption allocation is made.

If the premium has grown to a larger value or if the insured has died by the due date for the gift tax return, a timely GST exemption allocation should be made, thereby "leveraging" the amount protected from the GST tax.

## Filing Income Tax Returns for ILITs

### A. Income Tax Consequences to Insured as Grantor

Although many ILITs are drafted to try to avoid having the trust treated as a so-called "grantor trust," under which the income, deductions, and credits of the trust are attributed to the grantor, it is extremely difficult to avoid grantor trust status.

The typical ILIT will be a grantor trust under section 677(a)(3) of the I.R.C. because trust "income" (which for this purpose means taxable income, including capital gains) can be and is used to pay premiums on the life of the grantor and/or the grantor's spouse. Section 677(a)(3) provides that the grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, may be "applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse. . . ."

Under section 677(a)(3) the grantor may be taxed on the income of the trust even if the grantor did not transfer the policy to the trust; it is sufficient for the trustee to take out the policy after creation of the trust. In addition, it is not essential that the trust income be applied to pay premiums on the grantor's life;[55] the IRS takes the position that the grantor will be treated as the owner of any portion of a trust whose income, without consent of an adverse party, may be applied to the payment of premiums on insurance policies on the grantor's life.[56]

Although it may be possible to draft the trust to avoid the application of I.R.C. § 677(a)(3)—e.g., by requiring premiums to be paid only out of principal other than capital gains or by requiring the approval or consent of an adverse party—if the grantor's spouse is a beneficiary, the trust will still be treated as a grantor trust.

However, as a practical matter, grantor trust taxation should not be a concern if the trust will only hold life insurance policies, because the policy "build-up" is not currently taxable income. Moreover, under current tax rates, there are virtually no savings by "splitting" income between a grantor and the trust.

Indeed, grantor trust status may be extremely advantageous from a wealth transfer perspective. If the life insurance trust is a grantor trust and the grantor pays the tax on trust income, the grantor's payment of the tax should not be a considered a taxable transfer to the trust beneficiaries. However, in PLR 9444033, the IRS stated that, by paying the trust's tax liability, the grantor is treated as having made an additional transfer to the trust, unless the trust instrument provides for the reimbursement of the grantor from trust funds. In PLR 9504021, the IRS reiterated its position by stating that the reimbursement requirement "relieves the grantor from paying a liability that actually belongs to the trust (and, consequently, to the remainderman)."

This position was subject to considerable criticism. The IRS relented in PLR 9543049 by deleting the language in PLR 9444033 relating to the transfer tax implication of the grantor's payment of income tax on trust income.

Although the IRS appears to have backed off from its position that the grantor's payment of income tax is a gift to the trust beneficiaries, it may be advisable to include a discretionary reimbursement clause in any life insurance trust that is a grantor trust. If the IRS should reassert its position in the future, the reimbursement clause should prevent the grantor's payment of income tax from being treated as a gift. This clause, however, should be carefully drafted so that

the insured grantor does not, as a result of his or her ability to be reimbursed, have an incident of ownership in the property which would cause inclusion under I.R.C. § 2042 or an interest which would cause inclusion under section 2036.

Under certain circumstances, the grantor may desire to use grantor trust status. First, the grantor may be able to take advantage of any deductions the trust generates, especially if the trust itself does not have sufficient income to use all its potential deductions. And second, as discussed above, the grantor's payment of the trust's tax liability is, in effect, a transfer of wealth to the trust beneficiaries that is not subject to transfer tax.

### B. Income Tax Consequences to Beneficiaries

Depending on the terms of the irrevocable life insurance trust, there may be income tax consequences to individuals other than the grantor. For example, the IRS takes the position that a beneficiary's *Crummey* withdrawal power (including any cumulative "hanging" power) is a power described in section 678 of the I.R.C. which causes a portion of trust income to be taxed to the beneficiary under section 678(a)(1).[57] In Revenue Ruling 67-241, the IRS ruled that where a trust beneficiary holds a noncumulative power, exercisable solely by the beneficiary, to withdraw certain amounts of corpus annually from the trust, under section 678(a)(1), the beneficiary is treated for income tax purposes as the owner of that portion of the trust which could have been withdrawn by exercise of the power, whether or not it is exercised. Section 678(a)(1) provides that a person other than the grantor shall be treated as the owner of any portion of a trust which respect to which "such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself."

As the owner of a portion of the trust, items of trust income, deductions and credits attributable to the portion of the trust subject to the beneficiary's *Crummey* power are includable in computing the beneficiary's tax liability for the taxable year.[58]

The IRS also takes the position that the lapse of a *Crummey* withdrawal power will cause the powerholder to continue to be treated as the owner of the portion of the trust as to which the *Crummey* power lapsed.[59] Under I.R.C. § 678(a)(2), a *Crummey* powerholder who fails to exercise such power will be treated as if he or she partially released the power to withdraw a portion of the trust corpus.

Section 678(a)(2) provides that a person other than the grantor is treated as the owner of any portion of a trust with respect to which

> such person has previously partially released or otherwise modified such a power [to vest the corpus or the income therefrom in himself or herself] and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

In the typical life insurance trust, after the release by the powerholder of the power to withdraw a portion of trust corpus, under the terms of the trust the income or principal of that portion is required to be distributed (or may in the discretion of the trustee be distributed) to the powerholder or accumulated for future distribution to the powerholder. These are powers within I.R.C. § 677 which cause section 678(a)(2) to apply. Thus, the IRS argues that the powerholder will continue to have attributed to him or her the pro rata share of the items of income, deductions and credits of that portion of the trust that had been subject to the power that was released.[60]

Moreover, the IRS takes the position that during each succeeding year in which the powerholder fails to exercise his or her *Crummey* power, the powerholder will be treated as the owner of an increasing portion of the corpus of the trust.[61]

### C. Grantor v. Powerholders—Who Wins for Income Tax Purposes?

If the IRS's position is correct, under a literal reading of I.R.C. § 678(b) it would appear that the holders of powers of withdrawal or beneficiaries whose powers of withdrawal have lapsed will be treated as the owner of the income portion of the trust with the grantor treated as the owner of the remainder under section 677. Section 678(b) provides that "[s]ubsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section." It is not clear whether section 678(b) also applies to items relating to trust corpus over which a beneficiary has a power of withdrawal. Section 678(b) refers to "a power over income," but section 678(a)(1) refers to a power to vest "corpus or the income therefrom." Many commentators, however, believe that this was a drafting error by Congress and that section 678(b) is intended to apply to a power over income or corpus.[62]

The IRS's rulings appear to adopt this interpretation of section 678(b). In PLR 9141027, the IRS ruled that where the grantor is treated as the owner of the

income and corpus of the trust under section 677, holders of *Crummey* powers will not be treated as the owners of the trust under section 678. Similarly, in PLR 9309023, the IRS ruled that despite powers of withdrawal in the spouse-beneficiary which caused her to be treated as the owner of the portion of the trust subject to the power, because of section 678(b), the grantor is treated as the owner of the entire trust under section 677(a) since trust income and corpus may be distributed to the grantor's spouse.[63]

Accordingly, because all the income, credits and deductions of the ILIT will be attributed to the grantor while it is treated as a grantor trust, the trustee will not be required to file a federal income tax return for the trust. The trustee, however, must notify the grantor of the items the grantor must report on his or her income tax return.

After the trust ceases to be a grantor trust with respect to the grantor (e.g., the grantor dies), to whom is the income taxable? Applying the provisions of I.R.C. § 678(a)(1) and (2) literally, it would appear that the income of the trust should be taxable to the powerholders. However, this does not appear to be the IRS's position. In PLR 9026036, which as discussed below has been withdrawn and reissued, the IRS addressed the issue of whether the grantor of a trust, during her lifetime, would be treated as the owner for federal income tax purposes of the income of a trust created for her husband where her husband had the power to withdraw the property for 30 days after its contribution to the trust and whether, after the grantor's death the husband, if he survives the grantor, would be treated as the owner for federal income tax purposes of the income of the trust. The IRS ruled that the wife, during her lifetime, would be treated as the owner for federal income tax purposes of the income of the trust and, after her death, the husband would be treated as the owner for federal income tax purposes of the income of the trust. It appears that the IRS based its conclusion that the husband would be treated as the owner of the trust after his wife's death on the legislative history of section 678 which the IRS stated indicated Congress' intent to implement the principles of *Mallinckrodt*, *supra,* by treating the holder of certain powers as the owner of the trust. This would suggest that the IRS was treating the powerholder as having withdrawn the assets and then retransferred them back to the trust, thereby treating the powerholder as a new grantor to the trust.

However, in PLR 9321050, the IRS reconsidered the issues in PLR 9026036 and revised its ruling to hold that, after the death of the wife, the husband would *not* be treated as the owner for federal income tax purposes of the income of the trust. The only change in the IRS's analysis is a deletion of the discussion of legislative history to section 678. Thus, it appears that after a trust ceases to be treated as a grantor trust with respect to the grantor, the trust will be treated as a separate taxpayer for income tax purposes and the powerholders will not be treated as the owner of the income of the trust for federal income tax purposes.

Accordingly, upon the death of the grantor or if the trust otherwise ceases to be a grantor trust, the trust may be required—depending on whether the trust has any income: (1) to timely file federal fiduciary income tax returns (Form 1041); (2) to provide the beneficiaries of the trust with Form K-1 to the extent income is distributed to the beneficiaries; and (3) to file the appropriate state income tax returns.

## Fixing a Defective Trust

### A. Sale to Cure a Defective Trust

It appears that the special income tax rules which apply to ILITs may be used effectively in estate planning to remove an insurance policy from a defective insurance trust (e.g., a trust which has the prohibited hanging power language set forth in TAM 8901004) or a trust the dispositive provisions of which no longer meet the grantor's objectives. It may be possible to sell the policy to a new insurance trust, which is treated as a grantor trust for federal income tax purposes, that corrects the defects or has dispositive provisions consistent with the grantor's objectives.

### 1. Transfer for Value Considerations

Of initial concern in determining whether such a sale is feasible is whether the sale triggers the transfer-for-value rules. Section 101(a)(1) of the I.R.C. provides the general rule that gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured. Section 101(a)(2) provides an exception for transfers for valuable consideration:

> In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

An exception to this general rule is provided under section 101(a)(2)(B) where the transfer, for example, is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or

to a corporation in which the insured is a shareholder or officer. If the transfer is not within this exception to the transfer-for-value rules, the transferor may realize gain on the transfer to the extent the proceeds on the sale of the policy exceed the transferor's basis.

In the ordinary course, if a grantor contributes a life insurance policy on his or her own life to a trust, the transfer-for-value rule will not be triggered since the grantor did not receive valuable consideration for the property transferred.[64] What are the consequences, however, if the insured sells the life insurance policy to the trust, or the trustee of one trust decides to sell the life insurance policy to another trust created by the same grantor? Assuming that the trust to which the policy is being transferred is treated as a grantor trust (under I.R.C. § 677(a)(3) because the income of the trust may be applied to the payment of premiums on policies of insurance on the life of the grantor), the transfer-for-value rule should not be triggered. The IRS has taken the position that transfers between a grantor and a grantor trust will not be recognized for federal income tax purposes.[65] In accordance with this general principle, there has been an indication that the IRS and the courts similarly would take the position that a transfer to a grantor trust is a transfer to the "insured" within the meaning of section 101(a)(2)(B) and, thus, the net proceeds from the life insurance policies so transferred are excludible from gross income under section 101(a)(1).[66] Until recently, where this issue has been directly before the IRS, the IRS has declined to rule.[67]

However, in PLR 200120007, the IRS ruled that a transfer to a grantor trust is a transfer to the "grantor/insured" for purposes of section 101(a)(2)(B). In PLR 200120007, a husband created two trusts for the benefit of his three children. The trusts were funded with second-to-die insurance policies on the lives of the husband and his wife. The husband was treated as the owner of the trusts' assets for federal income tax purposes under I.R.C. § 677(a)(3) since the income of the trust may be applied for payment of premiums on life insurance on the life of the grantor. Each of the trusts entered into a split-dollar agreement with a corporation concerning two of their policies. The husband then created a third trust. The husband was also treated as the owner of the third trust's assets for federal income tax purposes. The wife created a fourth trust. The wife was treated as the owner of the fourth trust's assets for federal income tax purposes. The husband and wife created a fifth trust. The husband and wife were not treated as the owners of the fifth trust's assets for federal income tax purposes. The fifth trust was irrevocable on September 25, 1985. Husband, wife and the fifth trust formed an LLC. The husband transferred his interest in the LLC to the third trust. The wife transferred her interest in the LLC to the fourth trust. The husband and wife proposed for the first and second trusts to borrow from the cash value of one of their respective life insurance policies so the fifth trust could purchase those policies with its cash. The first and second trusts would transfer the policies to the fifth trust for cash equal to the policies' interpolated terminal reserve value. The first and second trusts would then transfer their remaining policies to the third and fourth trusts for cash.

The IRS first ruled that the LLC would be treated as a partnership for tax purposes. Because the husband is treated as the owner of the third trust's assets for federal income tax purposes, he will be treated as a partner in the LLC. Likewise, because the wife is treated as the owner of the fourth trust's assets for federal income tax purposes, she will be treated as a partner in the LLC. Accordingly, the husband, wife and the fifth trust will be treated as partners. The IRS further ruled that the transfers by the first trust and the second trust of the policies to the fifth trust will be "transfers for a valuable consideration." However, because the fifth trust will be a partner with both of the insureds (i.e., husband and wife), the transfer will satisfy the exception to the transfer-for-value rule in I.R.C. § 101(a)(2)(B) for a transfer to a partner of the insured. Additionally, because the husband is treated as the owner of the first trust's assets and the third trust's assets, the transfer of the policy from the first trust to the third trust will be disregarded for federal income tax purposes. The transfer of the policy from the second trust to the fourth trust will not be ignored for federal income tax purposes, but because the husband is treated as the owner of the second trust and the wife is treated as the owner of the fourth trust for federal income tax purposes, the wife will be treated as acquiring the policy from the husband by gift and not for value. Therefore, the "transfer-for-value" rule will not apply.

Accordingly, a sale should not trigger the transfer-for-value rule in section 101 if the trust to which the policy is being sold is a grantor trust with respect to the insured.

If such a sale is going to be put into effect, the practitioner should consider the following gift tax implications carefully:

### 2. Coordination of Powers of Withdrawal Under Both Trusts

If contributions will be made to both the selling trust and the purchasing trust during the same calendar year and similar beneficiaries have *Crummey* powers of withdrawal under both trust instruments, the grantor or trustee may wish to exclude certain beneficiaries from having withdrawal powers to avoid there

being a taxable gift because the beneficiary's power of withdrawal exceeds the gift tax annual exclusion amount, and to avoid there being a taxable lapse because of multiple powers of withdrawal which lapse above the "5 and 5" limitation.

#### 3. Borrowing Against the Policy

In order to reduce the amount that the grantor needs to transfer to the life insurance trust which will purchase the policy, the trustees of the trust which will sell the policy may wish to borrow against the cash value of the policy. In order to avoid there being a gift from the purchasing trust to the selling trust, the policy should be sold for its "interpolated terminal reserve amount" (e.g., the cash surrender value of the policy) *plus* the proportionate part of the gross premium last paid before the date of the sale and *less* any outstanding loans. Thus, to reduce the purchase price of the policy, the trustees of the selling trust could take out a loan against the cash value of the policy and sell the policy for a reduced amount to the purchasing trust. This would reduce the contribution which the grantor would need to make to the purchasing trust to buy the policy and thus the potential gift tax exposure. This may have the effect of eliminating any potential gift tax exposure (assuming that future contributions to the purchasing trust to pay the premiums on the policy and to repay the loan, including interest, could be protected from gift tax by the gift tax annual exclusion or unified credit) or, at a minimum, deferring the time at which gift tax must be paid. As to the amount of the loan to be taken out, there may be restrictions under the policy as to the percentage of the cash value which the owner may borrow.

### B. Using a Distribution to Cure a Defective Trust

As an alternative to selling the policy to a new trust, if the original trust permits the trustee may be able to distribute the policy to a new trust.

If the trust agreement does not so permit, state law may permit the trustee to distribute trust property to a trust for the benefit of the beneficiaries or in further trust for the benefit of the beneficiaries. For example, New York's EPTL 10-6.6(b) authorizes a trustee, who has absolute discretion, to invade the principal of a trust for the benefit of the beneficiaries of the trust to appoint such property in further trust for the benefit of the beneficiaries.

If such a distribution is made to a new trust or the trust property is appointed or paid over in further trust and the original trust is grandfathered for generation-skipping transfer tax purposes, the terms of the new trust should not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone the vesting of an interest beyond any life in being at creation of the trust plus 21 years.[68]

## Split-dollar Arrangements After Notice 2002-8

### A. Introduction

Split-dollar arrangements are arrangements under which the premium payments and/or the interests in life insurance policies are divided between different parties. In traditional split-dollar arrangements, the premium payments and interests are divided between the employer and the employee. Under the traditional endorsement method, the employer owns the life insurance policy and endorses to the employee[69] the right to name the beneficiary of the term component (the "at risk" portion) of the policy. Under the collateral assignment method, the employee owns the policy, names the beneficiary, borrows the premium from the employer, and then assigns an interest in the policy's death benefits/cash value to the employer.

In family split dollar, the arrangement is between the insured, a family member or entity created by the insured (which plays the role of the employer) and an ILIT (which plays the role of the employee). The ILIT is the applicant and owner of a life insurance policy on the insured's life and pays the part of the premium equal to the lesser of P.S. 58 (or Table 2001) rate and insurer's published premium rate for standard risk term insurance. The family member/entity pays the balance of the premium equal to increase in cash surrender value. The family member/entity is assigned the right to receive the greater of premiums paid or cash surrender value.

### B. Income Tax Consequences of Split-dollar Arrangements

#### 1. Revenue Ruling 64-328 and Its Progeny

Revenue Ruling 64-328, 1964-2 C.B. 11 (amplified in Revenue Ruling 66-100, 1966-1 C.B. 12 and Revenue Ruling 67-154, 1967-1 C.B. 11) had set forth the income tax consequences of a split-dollar arrangement between an employer and an employee.[70] In Revenue Ruling 64-328, an employer and an employee joined in purchasing a whole life policy on the employee's life. The employer paid the annual premium to the extent of the increase in cash surrender value (i.e., after the initial years, the entire premium). The employer was designated as the owner of the *lesser* of the cash value or the policy premiums it paid. The employee's beneficiary received the balance of the proceeds. Revenue Ruling 64-328 concluded that the employee is to be taxed on the value of the "economic benefit" received by reason of the employer's participation in the split-dollar arrangement. In the traditional arrangement at issue in the ruling, the benefit received by the employ-

ee was the right to designate the beneficiary of the portion of the death benefit consisting of "true" insurance coverage (the balance of the death benefit being payable to the employer). The ruling held that the table of one-year premium rates set forth in Revenue Ruling 55-747, 1955-2 C.B. 228, commonly referred to as the P.S. 58 rates, may be used to determine the value of the current life insurance protection provided to the employee under the split-dollar arrangement.

Revenue Ruling 66-110 amplified Revenue Ruling 64-328 by holding that an insurer's published term rates for one-year term insurance may be used to measure the value of the current insurance protection *if* those rates are ***lower*** than the P.S. 58 rates and available to all standard risks.

Revenue Ruling 67-154, 1967-1 C.B. 67, modified Revenue Ruling 66-110 by holding that an insurer's published term rates must be available for initial issue insurance in order to be substituted for P.S. 58 rates.

### 2. Notice 2001-10—Valuation of Life Insurance Protection Addressed

#### a. Revocation of Revenue Ruling 55-747 and P.S. 58 Table

In Notice 2001-10, 2001-05 I.R.B. 1, the IRS noted that the P.S. 58 rates set forth in Revenue Ruling 55-747, which are based on mortality tables originally published in 1946, *no longer bear an appropriate relationship to the fair market value of current life insurance protection.* Generally, for healthy individuals, the **P.S. 58** rates are significantly ***higher*** than the actual cost of the insurance protection attributable to the portion of the life insurance policy's death benefit. In some instances, use of the P.S. 58 rates in the employer-employee context causes some employees to report more gross income than is warranted under current conditions. Alternatively, certain arrangements, such as the so-called reverse split-dollar, have used the P.S. 58 rates to overstate significantly the value of the policy benefits allocated to the employer, thereby understating the value of the benefit conferred upon the employee. (In a reverse split-dollar, the P.S. 58 rate may be used to determine the employer's share of policy premiums, where the employer's interest in the life insurance policy is in a specified portion of the policy's death benefit.) The IRS stated that no published guidance authorizes reliance on the P.S. 58 rates for this purpose.[71]

***Revocation of P.S. 58 Rates***. Accordingly, the IRS revoked Revenue Ruling 55-747 and stated that it would *no longer accept P.S. 58* as a proper measure of current life insurance protection for federal tax purposes with respect to any tax year ending after December 31, 2001. The *IRS issued a new premium rate table (Table 2001)*, based on the mortality experience reflected in the table of uniform premiums promulgated under I.R.C. § 79(c), which may be used to determine the value of current life insurance protection on a single life provided under a split-dollar arrangement or qualified retirement plan for years ending after January 30, 2001.

***Modification of Application of Revenue Ruling 66-110***. Additionally, the IRS noted in Notice 2001-10 that, in some instances, the *published premium rates* used instead of the P.S. 58 rates to value current life insurance protection under split-dollar arrangements may *not be realistically available to all standard risks* who apply for term insurance, as required by Revenue Ruling 66-110 and other published authorities that have sanctioned that alternative valuation standard, and may vary among insurers. The IRS expressed concern that these rates are too low and are not uniform, which results in different treatments among taxpayers.

***Limitation of Use***: The IRS stated that taxpayers could continue to determine the value of current life insurance protection by using the insurer's lower published premium rates that are available to all standard risks for initial issue one-year term insurance as set forth in Revenue Ruling 66-110. However, for periods *after December 31, 2003*, the IRS would not consider an insurer's published premium rates to be available to all standard risks who apply for term insurance unless: (1) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, (2) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels, and (3) the insurer does not more commonly sell term insurance at higher premium rates to individuals that the insurer classifies as standard risks under the definition of standard risk most commonly used by that insurer for the issuance of term insurance. The IRS also stated that, with respect to any life insurance policy issued after March 1, 2001, it offered no assurance that taxpayers could use such published premium rates to determine the value of life insurance protection for periods after the later of December 31, 2003, or December 31 of the year in which further guidance relating to the valuation of current life insurance protection is published.

### 3. Notice 2002-8—Valuation of Life Insurance Protection Pending Further Guidance

Although Notice 2001-10 was revoked by Notice 2002-8, in Notice 2002-8, to address the concerns discussed in Notice 2001-10, the IRS revoked Revenue Ruling 55-747 (including the P.S. 58 table set forth therein) and established another set of standards for the valuation of current life insurance protection

pending the issuance of further guidance and final regulations.

The IRS advised that:

i. For split-dollar arrangements entered into *before 1/28/02* in which a *contractual arrangement between an employer and employee* provide that the *P.S. 58 rates* will be used to value the life insurance protection provided to the employee, the employer and employee may continue to use the P.S. 58 rates.

ii. For arrangements entered into before the effective date of future guidance, the taxpayers may use the *Table 2001* rates.

iii. For arrangements entered into before the effective date of future guidance, *to the extent provided in Revenue Ruling 66-110*, the taxpayers may use *the insurer's lower published premium rates* (query: is that lower than P.S. 58 or lower than Table 2001?) if available to all standard risks for initial issue one-year term insurance. However, after 12/31/03, published premium rates will not be considered as available to all standard risks *unless*

   (i) the insurer makes the rates known to persons who apply for term insurance, and

   (ii) the insurer regularly sells term insurance at such rates.

***Consequence on Revenue Ruling 66-110***. In a traditional split-dollar arrangement, the "economic benefit" to the employee will be, as of 1/28/02, the Table 2001 rates or the insurer's published term rates actually available to all standard risks (Revenue Ruling 66-110 standard), if lower than the P.S. 58 rate.

### 4. Reverse Split Dollar—Notice 2001-10

In this Notice, the IRS has stated that it also does not consider the P.S. 58 rate as the appropriate measure of the value of the benefit inuring to an employee under a reverse split-dollar arrangement. As noted above, the IRS suggests that taxpayers have used the P.S. 58 rates in reverse split dollar to overstate significantly the value of the policy benefits allocated to the employer, thereby understating the value of the benefit conferred upon the employee.

Although taxpayers may continue to use P.S. 58 rates for any tax year ending on or before December 31, 2001, it appears that the P.S. 58 rate may not be used for purposes of reverse split-dollar arrangements. Moreover, the Table 2001 rates, which presumably may be used for purposes of reverse split-dollar arrangements, are significantly lower than the P.S. 58 rates. Consequently, use of the Table 2001 rates for purposes of valuing the benefits inuring to an employee under a reverse split-dollar arrangement may significantly reduce, or eliminate, the equity shifting traditionally associated with reverse split-dollar arrangements.

### 5. Equity Split Dollar—Historically and Notice 2001-10

In contrast to the split-dollar arrangements described in Revenue Ruling 64-328 and Revenue Ruling 66-110, an employee's economic interest in a life insurance policy purchased under an equity split-dollar arrangement includes an agreed-upon portion of the policy's cash surrender value. Typically, in an equity split-dollar arrangement, the employer's interest in the policy's cash surrender value is limited to the aggregate amount of its premium payments, exclusive of any earnings. Consequently, the employee derives economic benefit from the employer's premium payments beyond the current life insurance protection discussed in Revenue Ruling 64-328.

In Notice 2001-10, the IRS advised that, under the general principles of Revenue Ruling 64-328 and Revenue Ruling 66-110, the employee's rights in the cash surrender value under an equity split-dollar arrangement must be included in the employee's income in a manner consistent with the parties' contractual position.

***Section 83 Approach***—In some circumstances, section 83 of the I.R.C. would apply to the split-dollar arrangement. Section 83 provides, as a general rule, that where property is transferred in connection with the performance of services, the person who performed the services must include in gross income an amount equal to the fair market value of the property so transferred in the first year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture. Life insurance is considered property for purposes of section 83.[72] Therefore, if the substance of the equity split-dollar arrangement involves a transfer of a beneficial interest in the cash surrender value of the life insurance policy from an employer to an employee, that economic benefit would be includable in the employee's gross income under section 83.

***Loan Approach***—However, where the employee is the beneficial owner of the life insurance policy from the inception of the arrangement, there is no transfer of property under section 83. In such circumstances, it may be appropriate to characterize the economic benefits to the employee as a below-market loan (a loan made in which the interest rate charged is less than the applicable federal rate), taxable under I.R.C. § 7872. Generally, in an employer-employee context, section 7872 recharacterizes a below-market loan

between an employer and an employee as two transactions. First, there is an arm's length transaction in which the employer makes a loan to the employee in exchange for a note requiring the payment of interest at the applicable federal rate. Second, there is a transfer of funds by the employer to the employee equal to the amount of "foregone interest" on the loan. The foregone interest would be includable in the employee's gross income. As support for the treatment of a split-dollar arrangement as a loan, the IRS noted that the legislative history to section 7872 indicates that the term "loan" should be interpreted broadly. Any transfer of money that provides the transferor with a right to repayment may be a loan.[73]

***Alternate Approaches*—**The IRS stated in Notice 2001-10 that, in light of the rationale set forth in Revenue Ruling 64-328 and the fact that no published guidance has addressed the potential applicability of section 7872 to split-dollar arrangements, pending consideration of public comments and the publication of further guidance, the characterization and income tax treatment of equity and other split-dollar arrangements will generally be determined under the following guidelines:

1. The IRS will generally accept the parties' characterization of the employer's payments under a split-dollar arrangement, provided that (i) such characterization is not clearly inconsistent with the substance of the arrangement, (ii) such characterization has been consistently followed by the parties from the inception of the arrangement, and (iii) the parties fully account for all economic benefits conferred on the employee in a manner consistent with that characterization.

2. The IRS will permit an employer's payments under a split-dollar arrangement to be characterized as loans for tax purposes, provided that all of the conditions set forth in paragraph 1 are satisfied. The tax consequences of the payments treated as loans will be determined under I.R.C. § 7872, the employee will not have additional compensation income for the value of the insurance protection provided under the life insurance policy, and the cash surrender value of the policy will not represent property that has been transferred to the employee for purposes of section 83. However, the employee ordinarily would have additional gross income if the employer's advances were not repaid in accordance with the terms of the arrangement. Moreover, the employee could have gross income under section 72 for distributions actually received under the life insurance policy.

3. In any case in which an employer's payments under a split-dollar arrangement have not been consistently treated as loans in accordance with paragraph 1, the parties will be treated as having adopted a non-loan characterization of the arrangement, and the parties must fully account for all of the economic benefits that the employee derives from the arrangement in a manner consistent with that characterization and with Revenue Ruling 64-328, Revenue Ruling 66-110, and the general tax principles upon which those rulings are based. In general, this means that (i) the employer will be treated as having acquired beneficial ownership of the life insurance policy through its share of the premium payments; (ii) the employee will have compensation income under section 61 equal to the value of the life insurance protection provided to the employee each year that the arrangement remains in effect, reduced by any payments made by the employee for such life insurance protection; (iii) the employee will have compensation income under section 61 equal to any dividends or similar distributions made to the employee under the life insurance policy (including any dividends applied to provide additional policy benefits), and (iv) the employee will have compensation income under I.R.C. § 83(a) to the extent that the employee acquires a substantially vested interest in the cash surrender value of the life insurance policy, reduced under section 83(a)(2) by any consideration paid by the employee for such interest in the cash surrender value.

4. Pending the publication of further guidance, the IRS will not treat an employer as having made a transfer of a portion of the cash surrender value of a life insurance policy to an employee for purposes of section 83 solely because the interest or other earnings credited to the cash surrender value of the policy cause the cash surrender value to exceed the portion thereof payable to the employer on termination of the split-dollar arrangement. If future guidance provides that such earnings increments are to be treated as transfers of property for purposes of section 83, it will apply prospectively.

5. In any case in which the employer's payments under a split-dollar arrangement have not been consistently treated as loans, then for so long as the arrangement remains in effect, the IRS will treat the employee as continuing to have gross income under I.R.C. § 61 for any current life insurance protection provided to the

employee under the arrangement, except to the extent allocable to premium payments made by the employee (or included in the employee's gross income under paragraph 6 below) or to any portion of the cash surrender value of the policy that has been treated as a substantially vested transfer of property to the employee under section 83. When such an allocation is required, the IRS will accept a pro rata or other reasonable method for determining that portion of the death benefit allocable to cash surrender value beneficially owned by the employer and that portion allocable to cash surrender value transferred to or purchased by the employee.

6. If an employer makes a premium or other payment for the benefit of an employee under a split-dollar arrangement, and the employer neither acquires a beneficial ownership interest in the life insurance policy through such payment nor has a reasonable expectation of receiving repayment of that amount through policy proceeds or otherwise, such payment will be treated as compensation income to the employee under section 61.

***Implications for Equity Split Dollar*****—**Although the implications of Notice 2001-10 with respect to a particular split-dollar arrangement will vary depending on the nature of the arrangement, the Notice has far reaching effects. Prior to the issuance of Notice 2001-10, many practitioners used the P.S. 58 rate or the insurer's published premium rates to determine the value of the benefit inuring to an employee under an equity split-dollar arrangement. It is now clear that the employee's rights in the cash surrender value under an equity split-dollar arrangement must be included in the employee's income in a manner consistent with the parties' contractual position, in addition to the value of the term insurance protection includable in an employee's gross income. The IRS' position will significantly decrease, and in some instances eliminate, the equity shifting from an employer to an employee, thereby making equity split-dollar a far less attractive vehicle for employee compensation.

### 6. Notice 2002-8's Proposed Regulations

In Notice 2002-8, the IRS also advised that it intended to issue proposed regulations requiring the taxation of parties to a split dollar life insurance arrangement under one of two mutually exclusive regimes.

***Economic Benefit Regime***. Under this regime, the economic benefits (i.e., term insurance coverage) are treated as transfers to the benefited party. That is, in an employment-related split-dollar arrangement, *if* the *employer* is the *owner* of the life insurance contract, then the benefits provided to the employee (such as current life insurance protection) are taxable under section 61 of the I.R.C. and the transfer of the life insurance policy is taxed under section 83. In this regime, the IRS notes that an employer will not be deemed to have made a transfer to an employee of a portion of the cash surrender value (CSV) because the interest or other earnings credited to the CSV cause the CSV to exceed what is payable to the employer.

***Loan Regime***. Under this regime, payments by the sponsor (the person providing life insurance benefits to the other party under the arrangement) pursuant to a split-dollar arrangement are treated as a series of loans to the benefited party. That is, if the employee is the owner of the life insurance contract under a split-dollar arrangement, then the premiums paid by the employer are treated as a series of loans by the employer to the employee if the employee is required to repay the employer. These loans are subject to the principles of I.R.C. §§ 1271–1275 (original issue discount) and section 7872 (below-market loans). If the employee is not obligated to repay the premiums paid by the employer, then such amounts are compensation income to the employee when the premiums are paid by the employer.

The proposed regulations will be effective for arrangements entered into after the date of publication of final regulations.

However, for split-dollar arrangements entered into prior to the date of publication of final regulations, the IRS in Notice 2002-8 also sets forth certain principles regarding the income tax treatment for such arrangements:

(i) A service recipient (the employer) will not be treated as having made a transfer of a portion of CSV to a service provider (the employee) under I.R.C. § 83 solely because the earnings credited to the CSV of the contract cause the CSV to exceed the portion payable to the service recipient (the employer).

(ii) Where life insurance protection is treated as an economic benefit (under section 61) provided by a sponsor (the employer) to a benefited person (the employee), the IRS will not treat the arrangement as being terminated (with a resulting transfer of property to the benefited person) if the parties treat the life insurance protection as an economic benefit provided to the benefited party (the employee).

(iii) The parties may treat and report premium and other payments as loans under I.R.C. §§

1271-1275 and 7872. All payments from the inception of the arrangement (before the first taxable year in which the payments are treated as loans) must be treated as loans entered into at the beginning of that first year in which such payments are treated as loans.

(iv) For arrangements entered into before 1/28/02, under which the sponsor (the employer) has made premium or other payments and is entitled to repayment of its payments, the IRS will not assert that there has been a taxable transfer upon termination of the arrangement if:

i. the arrangement is terminated before 1/1/04; or

ii. for all periods beginning on or after 1/1/04, all payments by the sponsor are treated and reported as loans under sections 1271–1275 and section 7872.

Finally, Notice 2002-8 states that taxpayers may rely on a reasonable application of the regulations to be proposed as discussed above or Notice 2001-10 for split-dollar arrangements entered into before the date of publication of final regulations.

### C. Gift Tax Consequences of Split-dollar Arrangements

#### 1. Revenue Ruling 81-198—Gift Tax Consequence of Split-dollar Arrangements

Where there is a so-called transfer of an interest in a so-called "split-dollar" arrangement, the IRS in Revenue Ruling 81-198, 1981-2 C.B. 188, has set forth the method for calculating the value of the gift. In Revenue Ruling 81-198, the employee owned a whole life insurance policy on the employee's life pursuant to a split-dollar arrangement with the employer. Under the arrangement, the employer paid the portion of the annual premium equal to the amount of the increase in cash surrender value of the policy each year and the employee paid the balance. The employee transferred all rights in the policy to a trust for the benefit of the employee's child. The IRS ruled that the value of the gift by the employee equaled the interpolated terminal reserve plus the proportionate part of the gross premium paid before the date of assignment, which covers the period extending beyond such date reduced by the amount of funds provided by the employer for premiums.

The IRS also ruled on the value for gift tax purposes of the gift that resulted from the split payment of annual premiums on the policy after the transfer of the policy to the trust. The annual premium payments by the employee as well as the value of the life insurance protection provided by the employer (which is included in the employee's income) are treated as gifts to the trust.

#### 2. Gift Tax Consequences Follow Income Tax Consequences

Although the law is not well developed, there is support (including in Notice 2001–10 and Notice 2002-8) for the conclusion that the gift tax effects under a private split-dollar arrangement between the insured (or a member of the insured's family) and a trust should be the same as the income tax effects with respect to a split-dollar arrangement between an employer and an employee (or a corporation and a shareholder).

In PLR 9636033, the taxpayer requested certain rulings concerning a private reverse split-dollar arrangement which the taxpayer's spouse proposed to enter into with an irrevocable trust. The taxpayer's spouse, who resided in a community property state, created an irrevocable trust. Under the trust, during the lifetime of the taxpayer, the net income and principal of the trust is to be paid at the discretion of the trustee to the taxpayer's issue. At the taxpayer's death, the trustee has discretion to distribute income and principal from the trust to the taxpayer's spouse and his issue. The taxpayer initially funded the trust with cash which was then used by the trustee to purchase a life insurance policy on the taxpayer's life. The trustee entered into a collateral assignment split-dollar agreement with the taxpayer's spouse. Under the agreement, the trustee is designated as the owner of the policy and is obligated to pay the portion of the annual policy premiums equal to the lesser of the applicable amount provided in the P.S. 58 tables and the current published premium rates for individual one-year term life insurance available to all standard risks of the insurance company issuing the policy. The spouse is obligated to pay the balance of the annual premium from her separate property. The split-dollar agreement can be terminated at will by either the trustee or the spouse. If the agreement is terminated prior to the taxpayer's death, the spouse is entitled to receive an amount equal to the cash value of the policy (net of any policy or premium loans or other indebtedness received by the spouse but secured by the policy). If the agreement is terminated as a result of the taxpayer's death, the spouse is entitled to receive an amount equal to the greater of the cash value of the policy immediately prior to the taxpayer's death or the total premiums that she has paid (less any outstanding policy or premium loans or other indebtedness received by the spouse that is secured by the policy.) In order to secure the spouse's interest in the policy, the trustee assigned to the spouse (under a collateral assignment agreement) the right to receive a portion of the proceeds payable on

the taxpayer's death equal to the spouse's interest, the right to receive the cash value of the policy if the policy is surrendered by the trustee (less outstanding loans made from the policy to the spouse) and the sole right to borrow against the policy. A promissory note evidencing the trust's indebtedness to the spouse was also executed.

The IRS ruled that the payment of the policy premium by the trustee and spouse pursuant to the terms of the split-dollar agreement will not result in a gift or deemed gift to the trust by the taxpayer's spouse. The IRS noted that, in consideration for paying a portion of the premiums, the spouse will receive the cash value of the policy. Since the spouse will be reimbursed for the premium payments, the IRS concluded the spouse's payment of the premium will not be subject to gift tax.

A similar result was reached in PLR 9745019, which is described in greater detail below. In PLR 9745019, the IRS ruled that since the insureds (who had entered into a split-dollar arrangement with a trust for the benefit of their children) would be reimbursed by the trust for the portion of the premium payments made by the insureds, the payment of such portion of the premiums would not be a taxable gift by the insureds.

Although Notice 2001-10 addresses only split-dollar arrangements in an employer-employee context, the Notice states that the IRS believes the same principles generally govern split-dollar arrangements in other contexts, including arrangements that provide compensation to non-employees and economic benefits to corporate shareholders and arrangements involving gifts. Similarly, although Notice 2002-8 addresses only split-dollar arrangements in an employer-employee context, the Notice states that these same principles are expected to govern split-dollar arrangements in other contexts, including arrangements that provide benefits in gift and corporation-shareholder contexts.

## D. Estate Tax Considerations

### 1. Inclusion of Proceeds Where Employee/Insured Retains Incidents of Ownership in Policy Within the Meaning of Section 2042

***Incident of Ownership Defined.*** A decedent's gross estate includes any policy of insurance where the decedent owned at death any of the incidents of ownership in the policy.[74] Although section 2042 of the I.R.C. does not specifically define the term "incidents of ownership," Regs. § 20.2042-1(c)(2) provides some guidance. "Incidents of ownership" is not limited in its meaning to ownership of the life insurance policy. More significantly it refers to the right of the insured or the insured's estate to the "economic benefits" of the policy. Thus, the term "incidents of ownership," for example, includes the power to change the beneficiary or contingent beneficiaries even if this right is exercisable only with the consent of the owner of the policy, to surrender or cancel the policy, to assign the policy, to pledge the policy for a loan, to obtain from the insurer a loan against the surrender value of the policy, or the power to change the time at, or manner in, which proceeds will be received, or the power to veto any change in beneficiary designation or an assignment or cancellation of the policy.

An insured is also deemed to have incidents of ownership if he or she has a reversionary interest in the policy or its proceeds which immediately before death exceeds five percent of the value of the policy. In valuing the insured's reversionary interest, the interests held by others are required to be taken into consideration. For example, if the insurance policy is subject to a split-dollar arrangement with the employer having the right to obtain the cash surrender value immediately before the insured's death, the insured would not be considered to have a reversionary interest in excess of five percent.[75]

***Attribution Rules.*** In addition, there are special attribution rules under I.R.C. § 2042(2) whereby an "incident of ownership" held by a corporation which the insured controls will be attributed to the insured. Where the insured is the sole or controlling (possessing more than 50 percent of the total combined voting power of the corporation) stockholder of a corporation, the corporation's incidents of ownership will be attributed to the insured except to the extent that the proceeds of the policy are payable to the corporation or to a third party in satisfaction of a business debt of the corporation or the insurance is group term life insurance described in section 79.[76]

There is no regulation for partnerships comparable to Regs. § 20.2042-1(c)(6), which attributes incidents of ownership held by a corporation to its controlling shareholder. However, the IRS has issued a revenue ruling, and there have been some cases, addressing the question of whether incidents of ownership in a policy of insurance owned by a partnership on the life of a partner will be attributed to the insured partner. Some of these cases can be read to suggest that incidents of ownership held by a partnership will never be attributed to the insured partner.[77] However, it may be that this is the rule only if the proceeds are payable to the partnership or acquired in the ordinary course of business by the partnership. The IRS, in any event, has so concluded by analogy to Regs. § 20.2042-1(1)(b), in Revenue Ruling 83-147, 1983-2 C.B. 158.[78] As in the case of a corporation, if

proceeds payable to a partnership were includable under the incidents of ownership test, there would be a double inclusion because the proceeds would also be reflected in determining the value of the insured's interest in the partnership. Indeed, this concern caused the IRS to rule in PLR 200111038 (December 15, 2000) that taxpayers did not have incidents of ownership over policies owned by a partnership in which they were limited partners.

In PLR 200111038, the IRS was asked to rule on the estate tax consequences of the transfer of life insurance policies by a trust to a limited partnership in which the insured individuals also are limited partners. In this case, the taxpayer and his wife established two trusts. One trust was for the benefit of the taxpayer's issue and parents. The other trust was for the benefit of the taxpayer's issue only. Subsequent to the creation and funding of these trusts, the trusts formed a valid limited partnership under state law. In return for a limited partnership interest, the first trust, Trust 1, contributed two second-to-die life insurance policies on the lives of the grantor and his spouse. In return for a general partnership interest, the second trust, Trust 2, contributed cash. The taxpayer and his spouse also contributed cash to the partnership in return for a limited partnership interest. In the facts as stated in the ruling, the limited partnership intended to designate itself as the beneficiaries of the policies, and represented that at no time would the net surrender value of the life insurance policies be 50 percent or more of the assets of the limited partnership. The taxpayer sought a ruling that the transfer of the life insurance policies by Trust 1 to the limited partnership will not cause either the taxpayer or his spouse, who were also limited partners of the partnership, to possess an "incident of ownership" over the trust property, such that the policies would be includable in either of their gross estates under I.R.C. § 2042(2).

In ruling favorably for the taxpayer, the IRS concluded that neither the taxpayer nor his spouse possessed an "incident of ownership" over the life insurance policies, and accordingly, the value of the policies would not be includable in their taxable estates. The IRS specifically referred to *Estate of Knipp v. Com'r*,[79] which held that a decedent's estate did not include proceeds of life insurance policies owned by a general partnership in which the decedent/insured was a 50 percent general partner where the policies were purchased in the ordinary course of business and payable to the partnership. The IRS, however, noted that in Revenue Ruling 83-147, 1983-2 C.B. 158, the IRS had ruled that, an insured partner possessed incidents of ownership in a life insurance policy on his life owned by a general partnership in which the insured was a general partner where the proceeds of the policy were payable to a third party for purposes unrelated to general partnership business. This Revenue Ruling was distinguishable from *Knipp*, according to the IRS, on the basis that in *Knipp* the proceeds in effect were includable in the decedent's estate through his ownership interest in the partnership. To also include the proceeds under I.R.C. § 2042(2) would result in unwarranted double taxation.

In this case the IRS noted that the partnership agreement itself precluded the limited partners from exercising any control over the management and investment decisions of the partnership and from taking part in control of the limited partnership's business, to sign for or bind the limited partnership in any way, to participate in the daily management of the limited partnership or to take part in its management or operations. The IRS thus concluded that the taxpayer and his spouse would not possess any incidents of ownership under I.R.C. § 2042(2). It is not clear from the ruling whether this conclusion is reached based on the lack of control that the insureds as limited partners would have over the insurance policies held by the partnership or based on a conclusion that the policies were acquired in the ordinary course of business by the partnership.

Therefore, it appears that if the insured is a limited partner and if state law and/or the partnership agreement prevents the insured from participation in the exercise of any partnership incidents of ownership with respect to the policy, incidents of ownership held by the partnership should not be attributed to the insured. If, on the other hand, the insured, as a partner, can participate in the partnership's exercise of incidents of ownership, it seems those incidents of ownership may be attributed to the insured (in a manner analogous to the treatment of a holder of more than 50 percent of the voting power of a corporation).

***Incident of Ownership in Part of Policy.*** In addition, it appears that all of the proceeds of a life insurance policy will be includable in an insured's estate if the insured holds any "incident of ownership" in *any portion* of the policy. Although it is possible to structure a split-dollar arrangement so that the insured would never exercise any incident of ownership, where a cash value policy is acquired, the insured (or an entity on behalf of the insured) may wish not only to "invest" in the cash value portion of the policy (by paying premiums which are credited to the cash value component) but to withdraw cash from the policy as well. The ability to withdraw cash from the policy appears to be an incident of ownership.[80]

Nevertheless, the IRS has ruled that all proceeds payable upon the death of the insured are included under I.R.C. § 2042(2) in the insured's estate when at

death the insured holds an incident of ownership in part, but not all, of the policy. In Revenue Ruling 79-129, 1979-1 C.B. 306, which concerned a *family* split-dollar arrangement between an insured and a trust created by the insured, the insured paid the premiums to the extent of the increase in cash surrender value of the policy during the year (just as the employer would under a traditional employer-employee split-dollar arrangement). The trust was the owner of the policy but under the terms of the policy the insured had the right to borrow against the cash surrender value (up to the amount of the premiums paid by the insured) and to receive (in his estate) the policy's cash surrender value less any indebtedness. The trust would receive the balance of the proceeds. The IRS ruled that the insured's right to borrow, although limited to the cash surrender value (the portion payable to the insured's estate), resulted in the inclusion of the entire proceeds in the insured's estate. In other words, the right to borrow against a portion of a policy was treated as an incident of ownership in the whole.

The IRS' position on this issue is, at best, questionable. For example, under Regs. § 20.2042-1(c)(5) only that portion (e.g., one-half) of the proceeds over which the insured spouse holds incidents of ownership in a policy held by the insured's spouse in a policy constituting a community property asset is includable in the insured's spouse's estate.

In Revenue Ruling 76-274, 1976-2 C.B. 278, however, the IRS had held that where a corporation's only incident of ownership under a split-dollar arrangement was the right to borrow against the policy's cash surrender value (up to the amount of its premium payments) and to reassign the policy to the insured, the corporation was merely a secured creditor. Therefore, the proceeds payable to the corporation were not includable in the insured's gross estate even though the insured was the controlling stockholder (to whom the corporation's incidents of ownership could be attributed pursuant to Regs. § 20.2042-1(c)(6)).

Revenue Ruling 76-274 appears first to have been undercut by the issuance of Revenue Ruling 79-129. Although Revenue Ruling 79-129 dealt with a family split-dollar arrangement between an insured and a trust, the IRS apparently believed the principles were sufficiently analogous to those of a corporate split-dollar arrangement to raise questions of inconsistency with Revenue Ruling 76-274. Therefore, the IRS issued Revenue Ruling 82-145, 1982-1 C.B. 213, concluding that if a controlled corporation has the right to borrow from a portion of a policy on the life of the controlling shareholder under a split-dollar arrangement, the corporation has incidents of ownership in the entire policy (which will be attributed to the controlling shareholder). The IRS reasoned that Revenue Ruling 76-274 neglected to comprehend that in the context of split-dollar insurance *any* incident of ownership pulls the *entire* amount of the policy proceeds into the gross estate, regardless of any limitation that may be imposed upon it, e.g., the ability to borrow only against the cash surrender value of the policy. The IRS also cited *Estate of McCoy*[81] and *Estate of Neuberger*, an unreported case.[82] In *Estate of McCoy*, the decedent owned a policy of insurance on his life naming his wife as the beneficiary. Pursuant to a property settlement agreement incident to divorce, the decedent was to designate irrevocably his wife and children as the beneficiaries of the life insurance policy. However, due to disputes between the decedent and his wife, at the time of his death his wife was still named as the sole beneficiary. Under the terms of the policy, the decedent could obtain loans from the policy to pay premiums, but apparently not otherwise. The Tax Court (relying in part on *Neuberger*) held that the right to borrow money upon the insurance policy, even though limited to the amount of premiums, constituted an incident of ownership sufficient to cause the entire proceeds to be included in the insured's gross estate.

However, while superficially consistent with Revenue Ruling 79-129 (which itself may or may not be correct), the IRS' analysis in Revenue Ruling 82-145 ignores certain applicable Treasury Regulations. These regulations suggest that there, in fact, may be a distinction between a split-dollar arrangement involving a corporation and one involving some other person (such as an individual). Regs. § 20.2042-1(a)(3) provides that, in general, the amount to be included in the gross estate, if there are incidents of ownership held by the insured is the full amount receivable under the policy. In the case of a controlled corporation, however, as discussed, Regs. § 20.2042-1(c)(6) establishes special rules. Under these rules, the corporation's incidents of ownership will not be attributed to the decedent through his or her stock ownership to the extent that proceeds of the policy are payable to the corporation. If *any part* of the proceeds of the policy are not payable to, or for the benefit of, the corporation, however—and thus are not taken into account in valuing the decedent's stockholdings in the corporation for estate tax purposes—any incident of ownership held by the corporation as to *that part* of the proceeds may be attributed to the insured, as the controlling shareholder. Regs. § 20.2042-1(c)(6) indicates that, in the case of a controlled corporation, incidents of ownership are to be analyzed separately as to the part of the proceeds payable to the corporation and the part payable to another person.

Although these rulings suggest that the IRS would contend that any incident of ownership held

directly by an insured or by a corporation of which the insured is the controlling shareholder with respect to any portion of a policy (such as the cash value component) under a split-dollar arrangement would "infect" the entire policy and cause the entire proceeds to be includable in the insured's estate for estate tax purposes, PLR 9745019 reached a different result where the insured's only right was to receive a portion of the proceeds or cash value of the policy equal to the insured's interest under the split dollar agreement upon death of the insured or surrender of the policy. In this ruling, a husband and wife created an irrevocable trust for the benefit of their children. The taxpayers retained no powers or authority over the trust, the trust property or its administration. One of the taxpayer's children was named as trustee of the trust. The taxpayers initially funded the trust with cash which the trustee then used to acquire a second-to-die life insurance policy on the taxpayers' lives. The trust was named as the owner and beneficiary of the policy. The taxpayers and the trustee proposed to enter into a collateral assignment split-dollar agreement with respect to any policies held by the trust. Under such agreement, the trustee is designated as the owner of the policy, is obligated during the taxpayers' lives to pay in effect the portion of the annual premium equal to the insurer's current published premium rate for term insurance, and is obligated, after the death of one of the taxpayers, to pay the portion of the premium equal to the lesser of the P.S. 58 amount or an amount equal to the insurer's current published premium rate for term insurance. The taxpayers agreed to pay the balance of the premium. If the agreement is terminated prior to the death of the survivor of the taxpayers, the survivor of the taxpayers is entitled to receive an amount equal to the cash surrender value of the policy (net of the cash surrender value at the end of the initial policy year). If the agreement is terminated as a result of the death of the taxpayers, the estate of the survivor is entitled to receive an amount equal to the cash surrender value of the policy immediately prior to the death of the survivor of the taxpayers (net of the cash surrender value at the end of the initial policy year). In order to secure the taxpayers' interest in the policy, the trustee assigned to the taxpayers the following rights: (1) the right to receive a portion of the proceeds payable on the survivor's death equal to the taxpayers' interest under the agreement, and (2) the right to receive the cash value of the policy if the policy is surrendered by the trustee. The taxpayers sought a ruling that the insurance proceeds payable to the trust pursuant to the split-dollar agreement from the second-to-die policy held by the trust would not be includable in the gross estate of the second taxpayer to die under section 2042. The IRS ruled that the proceeds would not be includable since the taxpayers have retained no incidents of ownership in the policy. In arriving at their determination, the IRS did not discuss the relevance of Revenue Ruling 79-129 or Revenue Ruling 82-145.[83] Accordingly, it appears that if the insured's only right under the split-dollar arrangement is to be "reimbursed" for the portion of the premiums paid, the insured may not have an incident of ownership in the policy.

These rulings, however, may not be helpful where a cash value policy is acquired and the insured (or an entity on behalf of the insured) wishes to "invest" in the cash value portion of the policy (by paying premiums which are credited to the cash value component) *and* to withdraw cash from the policy as well. The ability to withdraw cash from the policy appears to be an incident of ownership.[84] Under Revenue Ruling 82-145, such incident of ownership in part of the policy would cause the entire proceeds to be includable in the insured's estate.

**2. Application of Three-Year Rule Under Section 2035**

Where a decedent transfers a life insurance policy over which the decedent holds incidents of ownership within three years of the decedent's death, the proceeds of the policy will be includable in the decedent's estate, subject to the *Silverman* exclusion. Section 2035(a) of the I.R.C. includes, in a decedent's gross estate, the value of all property transferred during the three-year period ending on the date of the decedent's death for less than full and adequate consideration. Although section 2035(d) repeals this general three-year rule for estates of decedents dying after December 31, 1981, section 2035(d)(2) specifically carves out an exception to the three-year rule for an insurance policy where the insured has one or more incidents of ownership over the policy which would cause inclusion under section 2042 and the insured has assigned any such incident within the three-year period.[85] However, if the transfer occurs more than three years prior to the decedent's death, the proceeds should not be includable in the decedent's estate.

Example: An employee/insured has entered into a split-dollar arrangements and retains the right to designate the beneficiary of the "at risk" portion of the proceeds. The employee irrevocably assigns that right to an irrevocable insurance trust. The employee dies more than three years later. The proceeds should not be includable in the employee's estate.

## Collection of Insurance Proceeds

On the death of the insured, the trustee has the obligation to collect the proceeds of any life insurance policy held by the trust. To accomplish this goal, the trustee may be required: (1) to submit proof of the

insured's death to the insurance company; (2) to execute and deliver any receipt or other documentation for the proceeds required by the life insurance company; and (3) to collect the proceeds. Once the proceeds have been collected, the trustee must administer the proceeds in accordance with the trust agreement.

## Conclusion

In sum, the preparation of an insurance trust is only the beginning of the process of securing the grantor's objectives in creating the trust and making the trust fully operational. There are many steps which must be taken by the grantor or the trustee and many complicated issues which must be addressed by the grantor. Because many attorneys never have the opportunity to be actively involved in counseling the grantor or the trustee on the many issues discussed in this article, Appendix A contains a model letter to send to a client alerting the client to these issues so as to help ensure the client's objectives will be achieved.

## Endnotes

1. *See* Instructions to Forms SS-4 and 1041.
2. *See* § 2035.
3. *See* Rev. Rul. 76-490, 1976-2 C.B. 300; Rev. Rul. 78-420, 1978-2 C.B. 67; *Baratta-Lorton Est. v. Comr.,* T.C. Memo 1985-72, *aff'd*, 787 F.2d 597 (9th Cir. 1986) (unpub. op.).
4. Section 2503(b) provides for an exclusion from the gift tax for the first $10,000 (or $20,000 if the grantor is married and splits the gift with his or her spouse in accordance with § 2513) of present interest gifts by an individual during the calendar year. (Under § 2503(b)(2), this $10,000 amount is increased by a cost-of-living adjustment for gifts made in a calendar year after 1998 and currently in 2002 is $11,000.) In order to qualify as a gift of a present interest, the donee must have the unrestricted right to the immediate use, possession or enjoyment of the transferred property or the income from the property. Regs. § 25.2503-3(b).
5. *See* Regs. § 25.2503-3(a).
6. *See* Rev. Rul. 76-490, 1976-2 C.B. 300. *See also* Regs. § 25.2503-3(c), Example 6.
7. *See* Rev. Rul. 79-47, 1979-1 C.B. 312, *clarifying* Rev. Rul. 76-490, 1976-2 C.B. 300.
8. It is also possible to give the beneficiary the specific power to withdraw the policy. When a beneficiary holds this power, payments of premiums on the policy held by the trust are eligible for the gift tax annual exclusion. *See Halsted v. Comr.*, 28 T.C. 1069 (1957), *acq.*, 1958-1 C.B. 5. However, if the beneficiary predeceases the insured, the value of the life insurance policy at the beneficiary's death will be included in the beneficiary's gross estate because the power to withdraw the policy is a general power of appointment under § 2041.
9. *See* Rev. Rul. 80-261, 1980-2 C.B. 279.
10. *Crummey v. Comr.*, 68-2 USTC ¶ 12,541, 397 F.2d 82 (9th Cir. 1968). *See also Gilmore v. Comr.*, 54-1 USTC ¶10,948, 213 F.2d 520 (6th Cir. 1954); *Kieckhefer v. Comr.*, 51-1 USTC ¶ 10,812, 189 F.2d 118 (7th Cir. 1951).
11. *See* Rev. Rul. 81-7, 1981-1 C.B. 474.
12. *See* Rev. Rul. 81-7, 1981-1 C.B. 474; PLR 200123034; PLR 200011054; PLR 8229097; PLR 8143045; PLR 8143024; PLR 8008040.
13. *See* Rev. Rul. 81-7, 1981-1 C.B. 474.
14. *See* PLR 9030005; PLR 8922062.
15. 324 U.S. 18 (1945).
16. *See* PLR 200123034; PLR 200130030; PLR 200011054; PLR 199912016; PLR 9745010; PLR 9311021; PLR 9232013; PLR 9218040; PLR 9030005; PLR 8712014; PLR 8134135; PLR 8103074.
17. 97 T.C. 74 (1991).
18. *See, e.g.*, PLR 8022048. *See also* TAM 9141008 (suggesting that 20 days may not be a reasonable period of time); TAM 9628004 (providing four or fewer days to exercise withdrawal right in year trust was created showed that donor did not intend at creation to make bona fide gifts of present interests and allowance of adequate time to exercise powers in later years did not change that intent; exclusions denied for all years).
19. *See, e.g.*, PLR 8022048; PLR 7922107.
20. There may be other reasons why it is advisable to exclude a beneficiary from having a power of withdrawal such as the beneficiary is estranged from the family and will upset the estate plan by exercising the power or the beneficiary has creditor problems and, under applicable state law, the beneficiary's creditors can reach any property subject to a general power of appointment such as a power of withdrawal.
21. *See* Rev. Rul. 73-405, 1973-2 C.B. 321; PLR 8712014; PLR 8701007; PLR 8445004.
22. *See*, *e.g.*, PLR 8229097; PLR 8143045; PLR 8143024; PLR 8008040.
23. *See* PLR 9030005; PLR 8008040.
24. *See, e.g.*, PLR 8143045; PLR 8138102; PLR 8133070; PLR 8121069.
25. *See, e.g.*, PLR 8143045; PLR 8138170; PLR 8138102; PLR 8021058.
26. *See* PLR 8143045; PLR 8138102; PLR 8133070; PLR 8121069.
27. *See also* Rev. Rul. 76-490, 1976-2 C.B. 300.
28. *See*, *e.g.*, PLR 8111123 (a contribution qualified for the gift tax annual exclusion where the beneficiaries had withdrawal rights which could be satisfied with "[a]ny trust assets, including any life insurance policies"); PLR 8134135; PLR 8021058. *But see* PLR 8118051 (a contribution to a trust qualified for the gift tax annual exclusion where the beneficiary had a withdrawal right but only "to the extent that there is cash, or assets reducible to cash, in the trust to satisfy any beneficiary demand rights").
29. *See* PLR 8008040; PLR 7947066; PLR 7826049.
30. *See also Vinikoor v. Comr.*, T.C. Memo. 1998-152.
31. *See Guggenheim v. Rasquin*, 312 U.S. 254 (1941). *See also* GCM 38110 (Sept. 25, 1979).
32. Regs. § 25.2512-6(a), Example (3).
33. Regs. § 25.2512-6(a).
34. *United States v. Ryerson*, 312 U.S. 260 (1941); *Tuttle v. United States*, 71-1 USTC ¶ 9,140, 436 F.2d 69 (2d Cir. 1970). *See also Pritchard v. Comr.*, 4 T.C. 204 (1944); *Meltzer Est. v. Comr.*, 71-1 USTC ¶ 12,754, 439 F.2d 798 (4th Cir. 1971) (in the case of simultaneous death of the owner and insured, the interpolated terminal reserve with adjustments method of valuation should be used to value life insurance for estate tax purposes); *Old Kent Bank and Trust Co. v. United States*, 70-2 USTC 12,703,

430 F.2d 392 (6th Cir. 1970); *Chown Est. v. Comr.*, 70-2 USTC ¶ 12,702, 428 F.2d 1395 (9th Cir. 1970); *Marks Est. v. Comr.*, 94 T.C. 720 (1990). *But see Wien Est. v. Comr.*, 71-1 USTC ¶12,764, 441 F.2d 32 (5th Cir. 1971) (it is not proper to look at imminence of insured's death in valuing life insurance).

35. *See United States v. Ryerson, supra*.
36. *See* I.R.C. § 2613(a).
37. *See* I.R.C. § 2612.
38. I.R.C. § 2612 (c).
39. *Cf*. TAM 8901004 (holding that, to the extent any skip person has a *Crummey* withdrawal power any transfer to the trust over which such skip person has a *Crummey* power is treated as a "direct skip" to the skip person. TAM 8901004 was drafted prior to the act enactment of the amendment to section 2642 setting forth the availability of the nontaxable gift exclusion for transfers to trusts.)
40. *See* I.R.C. § 2631.
41. I.R.C. § 2632(b)(1) and (3); Regs. § 26.2632-1(b)(1).
42. Regs. § 26.2632-1(b)(1).
43. Regs. § 26.2632-1(b)(1)(ii).
44. Regs. § 26.2632-1(b)(1)(i).
45. Regs. § 26.2632-1(b)(2)(i).
46. Regs. § 26.2632-1(b)(2)(ii)(A)(1).
47. Regs. § 26.2632-1(b)(2)(i).
48. I.R.C. § 2631(b); Regs. § 26.2632-1(b)(2)(ii)(A)(2).
49. Regs. § 26.2642-2(a)(2).
50. *See* I.R.C. § 2642(f)(4).
51. *See* Regs. § 26.2632-1(c)(3).
52. *See* Regs. § 26.2632-1(c)(1).
53. *See* I.R.C. § 2642(f)(2).
54. Regs. § 26.2632-1(c)(1).
55. S*ee Strockstrom v. Comr.*, 3 T.C. 664 (1944).
56. *See* PLR 8852003; *Rieck v. Comr.*, 41 B.T.A 457 (1940), *aff'd*, 41-1 USTC ¶ 9,246, 118 F.2d 110 (3d Cir. 1941). *But see Comr. v. Mott*, 36-2 USTC ¶ 9,391, 85 F.2d 315 (6th Cir. 1936); *Weil v. Comr.*, 3 T.C. 579 (1944), *acq.*, 1944 C.B. 1; *Moore v. Comr.*, 39 B.T.A. 808 (1939).
57. Rev. Rul. 67-241, 1967-2 C.B. 225; PLR 9745010; PLR 9625031; PLR 9541029; PLR 9535047; PLR 9504024; PLR 9450014; PLR 8142061.
58. I.R.C. § 671. A pro rata share of deductions and credits available to the trust must be allocated to the portion as to which the beneficiary is treated as the owner by virtue of § 678(a)(1). *See* Regs. § 1.671-3.
59. *See* PLR 9745010; PLR 9625031; PLR 9535047; PLR 9504024; PLR 9034004; PLR 8701007; PLR 8521060; PLR 8517052.
60. *See* PLR 9034004; PLR 8521060.
61. *See* PLR 9034004.
62. *See* Jonathan E. Gopman, Esq., *The Income Tax Consequences of an Irrevocable Life Insurance Trust*, 22 Tax Mgmt. Estate, Gifts & Trusts J. 211 (Sept./Oct. 1997).
63. *See* PLR 8929040; PLR 8701007; PLR 8326074; PLR 8126047; PLR 8118051; PLR 8103074.
64. *Cf.* Regs. § 1.101-1(b)(2).
65. *See* Rev. Rul. 85-13; PLR 8718046; PLR 8636053. *But see Rothstein v. United States*, 84-1 USTC ¶ 9,505, 735 F.2d 704 (2d Cir. 1984).
66. *See Swanson v. Comr.*, 75-2 USTC ¶ 9,528, 518 F.2d 59 (8th Cir. 1975). *Terriberry v. United States*, 74-2 USTC ¶ 13,002 (M.D. Fla. 1974), *rev'd on other grounds*, 75-2 USTC ¶ 13,088, 517 F.2d 286 (5th Cir. 1975). *See also* PLR 9033023.
67. *See* PLR 9511009; PLR 9413045.
68. *See* Regs. § 26.2601-1(b)(4)(A).
69. The split-dollar arrangement may also be entered into between an employer and the trustee of a trust created by the employee or a third party.
70. *See also* PLR 8547006. The IRS applies different rules for split-dollar arrangements in effect before November 14, 1964. *See* Rev. Rul. 55-713, 1955-2 C.B. 23.
71. *But see PLR 9636033* (IRS approves use of lower of P.S. 58 rates or published premium rates for private split-dollar plan).
72. *See* Regs. § 1.83-3(e).
73. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1018 (1984), 1984-3 (Vol. 2) C.B. 272.
74. I.R.C. § 2042(2).
75. Regs. § 20.2042-1(c)(3).
76. Regs. § 20.2042-1(c)(6). *See also* Rev. Rul. 82-141, 1982-2 C.B. 209; PLR 9037012.
77. *Estate of Knipp v. Comr.*, 25 T.C. 153 (1955), *aff'd on another issue*, 242 F.2d 436 (4th Cir.), *cert. denied*, 355 U.S. 827 (1957). *See also Atkins v. Comr.*, 2 T.C. 332 (1943) (cited in *Knipp*) (considering an insurance exclusion under the 1939 Code, but also containing strong language to the effect that a policy of insurance owned by a partnership is considered property of the partnership rather than of the individual partners); *Watson v. Comr.*, 36 T.C.M. (CCH) 1084 (1977) (issue was whether decedent or his partner owned the policy, but court stated also that if the partnership, rather than the partner, had become the owner, the decedent still would not have had incidents of ownership, citing *Knipp*). *Cf. Fuchs v. Comr.*, 47 T.C. 199 (1966) (Acq.) (policies of insurance on lives of co-partners); *Infante v. Comr.*, 29 T.C.M. (CCH) 903 (similar).
78. *See also* Rev. Rul. 83-147, 1983-2 C.B. 159 (group term insurance).
79. 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue*, 244 F.2d 436 (4th Cir. 1957), *cert. denied*, 355 U.S. 827 (1957).
80. *See* Regs. § 20.2042-1(c)(2) stating that the power to surrender a policy or to obtain a loan against the surrender value of the policy are incidents of ownership. *See also St. Louis Union Trust Company v. United States*, 262 F. Supp. 27 (1966) (holding that the right to "all payments, dividends, surrender values, options and benefits of any kind, which may accrue" under a life insurance policy was an incident of ownership); Rev. Rul. 79-129, 1979-1 C.B. 306 (holding that the "right to borrow against the cash surrender value of the policy to the extent of the premiums paid" is an incident of ownership).
81. 20 T.C.M. 224 (1961).
82. 42-2 USTC ¶ 10,208 (N.D.N.Y. 1942).
83. *See also* PLR 9709027; PLR 9746004.
84. *See* Regs. § 20.2042-1(c)(2) stating that the power to surrender a policy or to obtain a loan against the surrender value of the policy are incidents of ownership. *See also St. Louis Union Trust Company v. United States*, 262 F. Supp. 27 (1966) (holding that the right to "all payments, dividends, surrender values, options and benefits of any kind, which may accrue" under a life insurance policy was an incident of ownership); Rev. Rul. 79-129, *supra*. (holding that the "right to borrow against the cash surrender value of the policy to the extent of the premiums paid" is an incident of ownership).
85. Regs. § 20.2042-1(c)(2)

## APPENDIX A

### MODEL LETTER TO CLIENT REGARDING OPERATION OF ILIT

[DATE]

PERSONAL AND CONFIDENTIAL

[NAME]
[ADDRESS]
[ADDRESS]

Re: The ________________ Life Insurance Trust

Dear :

I am enclosing a final execution copy of your irrevocable life insurance trust. You should sign where indicated in the presence of a notary public who should fill in the county and date, sign and affix his or her stamp and/or seal where indicated. I would then appreciate your arranging to have the trustees sign the Agreement where indicated, also in the presence of a notary public.

After the Agreement has been executed, there are certain mechanical steps that you or ________________ and ________________, as trustees, will need to take in order to get the trust operative and in order to preserve the potential gift and estate tax advantages of the trust. In particular, the following will need to be taken care of:

1. If any insurance policies on your life will be contributed to the trust, you will need to execute the appropriate change of owner/beneficiary forms required by the insurance company and file these forms with the insurance company. Please let me know if you would like our assistance in obtaining and completing the appropriate forms.

2. If the trust will acquire policies of insurance on your life, the trustees should contact your insurance agent and apply directly for the insurance. In order to avoid having the policy possibly includable in your estate, you should *not* be the applicant for the insurance.

3. The trustees should open a bank account to which you will be making contributions that will enable the trustees to pay the premiums on the policies.

   Please note that you should make all direct or indirect contributions to the trust from your *separate* assets (e.g., *not* from a joint account). This is to prevent any portion of the trust from being included in your spouse's estate on his or her death.

4. Your trustees will need to arrange to have the holders of powers of withdrawal (e.g., *your spouse and your children)* waive their right to receive notification of additions to the trust. I have enclosed the waiver forms which need to be executed. In addition, your trustees should notify the power holders (e.g., *your spouse and children*) every time a contribution is made to the trust. (This will occur, for example, if you make a transfer of cash to the trust or pay directly a premium on a policy held by the trust). The reason that we recommend that the notification be given is that the IRS has indicated in a recent ruling that an execution of a waiver of the right to receive notification of contributions to a trust would jeopardize your

ability to have your transfers to the trust qualify for the $11,000 annual exclusion from gift tax. We recommend that waivers, nevertheless, be executed to provide you with an argument that the transfers are eligible for the $11,000 annual exclusion in the event your trustees forget to send out the notification letters. I am enclosing model notification letters to be sent to your spouse and your children. Please let me know if you need any help in completing the blanks in the letters.

5. You will need to consult with your accountant concerning whether or not you have made a taxable gift as a result of the transfers to the trust (in conjunction with any other gifts you have made to your children) and whether a federal and state gift tax return needs to be filed and gift tax paid. In addition, if you intend to have your exemption from the generation-skipping transfer tax allocated to transfers to the trust or not allocated to transfers to the trust, you should so advise your accountant at the time you transfer property to the trust so that your accountant may make the appropriate allocation of your exemption or election not to have your exemption allocated on your federal and state gift tax returns and make sure that the allocation or election is timely made (e.g., by April 15 of the year following the year in which the transfer to the trust occurred).

6. In addition, you will need to consult with your accountant concerning the need to file federal and state income tax returns for the trust. During your life, because it is anticipated that the trust will only hold life insurance policies on your life, will have no income and will be treated as a "grantor trust," it will probably not be necessary to file any income tax returns. However, after your death, when the proceeds of any insurance policy will be distributed to the trust, the trust will be required to file income tax returns.

Please let me know if you wish us to keep the original of the Trust Agreement for safekeeping. I would appreciate your nevertheless sending me a copy of the execution pages of the Trust Agreement as well as copies of the executed waivers of notification.

I would be delighted to answer any questions you may have concerning the execution of the trust or the steps necessary to make the trust operable.

Best regards.

Sincerely yours,

# Retirement Plan Assets in Bankruptcy

By David A. Pratt

## Introduction[1]

This article describes the issues that arise upon the bankruptcy of an individual who is (1) a participant or beneficiary under an employer-sponsored retirement plan or (2) the owner or a beneficiary of an individual retirement account (IRA), including a rollover IRA. It does not address issues arising on the bankruptcy of the sponsoring employer,[2] or issues relating to health and welfare plans.

## The Anti-Alienation Rules

Both the Internal Revenue Code (the "Code") and ERISA generally prohibit the assignment or alienation of retirement plan benefits.[3]

The Code provision only applies to qualified plans that are subject to the minimum vesting standards, so does not apply to non-qualified plans, governmental plans or non-electing church plans.[4]

The ERISA provision applies to pension plans (qualified or non-qualified), as defined in ERISA section 3(2), and thus does not apply to plans that are exempt from ERISA, such as governmental plans, church plans and plans that cover no common law employees.[5] Neither provision applies to an IRA, including an employer-sponsored IRA arrangement such as a SEP or SIMPLE IRA.[6] The ERISA anti-alienation rule *does* apply to funded non-qualified plans, including plans that were previously qualified.[7]

## Is the Participant's Accrued Benefit Under an Employer-Sponsored Retirement Plan Includible in the Bankruptcy Estate?

### In General

There are three provisions of the federal Bankruptcy Code[8] which are directly relevant to this issue.

1. The general rule under section 541(a) is that all of the debtor's property is included in the bankruptcy estate.
2. Section 541(c)(2) *excludes* from the bankruptcy estate property that is subject to a restriction on transfer that is enforceable under "applicable nonbankruptcy law." In *Patterson v. Shumate*,[9] the Supreme Court held that the ERISA anti-alienation rule is such a restriction and, accordingly, that the debtor's benefits under his employer's qualified plan were excludible from his bankruptcy estate under section 541(c)(2). Unfortunately, however, the Court described its holding as applying to ERISA-qualified plans," thus creating uncertainty as to the scope of its holding: see below.
3. Section 522(d)(10)(E) of the Bankruptcy Code allows a debtor to claim an exemption from the bankruptcy estate, in those states where a debtor is allowed to claim the federal exemptions, for the right to receive "a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract . . . , to the extent reasonably necessary for the support of the debtor and any dependent of the debtor."

## What Is an "ERISA-Qualified Plan"?

The holding in *Shumate* applies to "ERISA-qualified plans." There are several possible interpretations of this term[10]:

### The Plan Need Only Be Qualified

The first possible interpretation is that the plan need only be qualified, and need not be subject to ERISA. A qualified plan is one that satisfies the numerous qualification requirements set out in the Code.[11] Most (but not all) plans apply for, and receive, a determination letter from the IRS that they are qualified or, in the case of a prototype or volume submitter plan, are entitled to rely on a favorable opinion letter issued by IRS to the plan sponsor. However, a plan may lose its qualification (i) if it is not updated to comply with changes in the law or regulations, or (ii) if it is operated improperly. Because of the complexity of the rules, almost every qualified plan has, at some time, been subject to an error that could, theoretically, have resulted in formal disqualification by IRS. IRS, however, recognizes that compliance is difficult, and very rarely actually disqualifies a plan: almost always, the plan will correct the errors under an IRS correction program.

*Witwer*[12] involved a plan that was qualified but not subject to ERISA. The debtor argued that Code section 401(a)(13) protected the assets in bankruptcy. The court disagreed: unlike ERISA section 206(d), section 401(a)(13) could not be enforced by a plan participant or beneficiary, and thus was not "enforceable." Thus, the benefits were not excludable under section 541(c)(2).

### The Plan Need Not Be Qualified, But Must Be Subject to ERISA

Numerous courts have held that the key issue is that the plan must be subject to ERISA.[13] Courts taking this position have generally also held that ERISA violations do not make ERISA inapplicable.[14]

If the plan is subject to ERISA, the debtor's control over the employer or the plan is irrelevant. For instance, in *Shumate* the debtor owned over 90 percent of the employer's stock.[15]

### The Plan Must Be Both Qualified and Subject to ERISA

Several courts have held that, in order to be "ERISA-qualified," the plan must be both qualified and subject to ERISA.[16]

### Who Determines Whether the Plan Is Qualified?

Some bankruptcy courts have taken it upon themselves to determine whether a plan is, in fact, qualified. In *Dzikowski*, for example, the court held that, despite a favorable determination letter, the bankruptcy court must inquire into the plan's qualification in operation before ruling that the plan is qualified.[17] Other courts have held that this is inappropriate, particularly if IRS has recently reviewed the plan.[18]

### What if the Plan Is Not "ERISA-Qualified"?

Even if the plan is not within the scope of the *Shumate* ruling, it may still be protected against creditors' claims under state law. Thus, for instance, in *Moses*,[19] the court held that assets under a non-ERISA plan (only owners were participants) may also be protected, under state spendthrift trust law.

Generally, state spendthrift trust law will apply only if the debtor does not control the employer and has no right to withdraw funds from the plan until death, disability, retirement or termination of employment.[20] Some courts have extended spendthrift trust treatment to plans funded by elective deferrals.[21] However, the plan will not qualify as a spendthrift trust if the debtor controls the employer or plan.[22]

A retirement plan which is not subject to either of the statutory anti-alienation rules, such as a governmental plan, may include an enforceable spendthrift clause. For instance, IRS has ruled in field service advice that a governmental 403(b) annuity could be excluded from the participant's bankruptcy estate, although the plan was not subject to ERISA, if the restrictions were determined by the bankruptcy court to be enforceable under state law.[23]

Also, federal civil service retirement benefits are "[n]ot assignable, either in law or equity, [or] subject to attachment, garnishment, or other legal process, except as otherwise may be provided by Federal laws."[24]

Accordingly, such benefits have been held to be excludable from the bankruptcy estate.[25]

None of these provisions will protect the individual against the enforcement of a tax lien by the IRS: Code sections 6321 and 6334 contain no exemption for pension plans.[26]

In addition, state laws governing creditors' rights frequently grant exemptions for benefits under certain categories of employer-sponsored retirement plans and/or IRAs. It is essential to review the exact language of the state law to determine whether creditors can argue that the exemption does not apply in a particular case.[27]

## New York Law

An individual debtor domiciled in New York may exempt from the bankruptcy estate, to the extent provided in section 522(b) of the Bankruptcy Code:[28]

1. Any property exempt from application to the satisfaction of money judgments under C.P.L.R. sections 5205 and 5206. The C.P.L.R. protects, against claims of creditors, any trust, custodial account, annuity, insurance contract, monies, assets or interests established as part of, and all payments from

    1. An individual retirement account or annuity (IRA);
    2. A Roth IRA;
    3. A Keogh plan or corporate plan that is qualified under Code section 401(a);
    4. Any trust, etc. created as a result of a rollover from any such plan; and
    5. A deferred compensation plan of a governmental or tax exempt employer that satisfies the requirements of Code section 457.[29]

All such trusts, etc. are conclusively presumed to be spendthrift trusts, for all purposes, including the Bankruptcy Code, and are considered to have been created by or to have proceeded from a person other than the judg-

ment debtor, even where the debtor is in fact the creator of the account.[30] The exemption does not apply to additions to the account (1) made less than 90 days before the interposition of the claim on which the judgment was entered or (2) that are deemed to be fraudulent preferences under Article 10 of the Debtor and Creditor Law.[31]

2. Insurance policies, annuity contracts and the proceeds thereof, as provided in section 3212 of the Insurance Law.

3. The right to receive the following benefits:

   a. Social Security, unemployment compensation or a local public assistance benefit.

   b. A veterans' benefit.

   c. A disability, illness, or unemployment benefit.

   d. Alimony, support or separate maintenance, to the extent reasonably necessary for the support of the debtor and any dependents of the debtor.

   e. Payments under a stock bonus, pension, profit sharing or similar plan or contract on account of illness, disability, death, age or length of service, unless

      i. The plan or contract is not "qualified" under Code section 401 (qualified plans), 408 (IRAs) or 408A (Roth IRAs) and was established by the debtor or under the auspices of an insider that employed the debtor at the time the debtor's rights under the plan or contract arose;

      ii. The plan is on account of age or length of service; and

      iii. The plan or contract does not qualify under section 401(a) (qualified plans), 403(a) (annuity plans), 403(b) (tax-sheltered annuities), 408 (IRAs), 408A (Roth IRAs), 409 (ESOPs) or 457 (deferred compensation plans of governmental and tax-exempt employers) of the Code.[32]

## Plan Loans

Many plans (particularly 401(k) plans) allow participants to borrow from the plan. Most cases have held that a plan loan is not a dischargeable debt.[33]

The trend of recent cases is to hold that payroll deductions to repay a plan loan must be included in a chapter 13 debtor's disposable income.[34] "Consequently, a post-petition chapter 13 debtor may continue to make payments on a plan loan outside the chapter 13 plan only if the debtor's chapter 13 plan provides for payment of 100 percent of the creditors' claims."[35]

The chapter 13 debtor may not be forced by creditors to borrow from the plan in order to provide disposable income to pay creditors.[36]

## Employee Contributions

A chapter 13 debtor's elective deferrals under a 401(k) plan or similar arrangement are part of his or her disposable income, not necessary expenditures for his or her support and maintenance. By contrast, employee contributions to a governmental plan, and required by state statute, may or may not be part of disposable income, depending on the facts of the case.[37]

## Effect of Bankruptcy on the Debtor's Obligations or Rights Under a Qualified Domestic Relations Order (QDRO)

If the plan participant is the debtor, then

1. If plan benefits are excludable from the bankruptcy estate under *Shumate*, then the bankruptcy should have no adverse effect on the alternate payee, unless state law allows the debtor to seek modification of the QDRO in light of the bankruptcy.

2. The obligation under the QDRO is not discharged in the bankruptcy. In *Gendreau*,[38] the participant filed a bankruptcy petition under Chapter 7 before the QDRO was approved, and then sought a declaratory judgment that the award to his wife of part of his pension benefits was a dischargeable debt. The court held that the QDRO, when issued and approved by the plan, would be enforceable

against the plan, rather than the debtor, and thus would not be discharged.

3. If the QDRO has already assigned to the alternate payee a share of the participant's accrued benefit under the plan, it appears that the participant no longer has any property interest in the portion assigned to the alternate payee, so that it would not be included in the estate in any event. In *Lowenschuss*,[39] the divorce court awarded the wife 38.7 percent of the debtor's benefits under a plan that was not subject to ERISA because the debtor, the self-employed owner of the plan sponsor, was the only participant. The court held that the wife was deemed to own the portion awarded to her, rather than merely holding a money judgment, so her interest was not subject to discharge. A shared payment QDRO may not be as well protected, particularly if the plan is not covered by *Shumate*.

If the alternate payee is the debtor, then the position of the alternate payee should be the same as if he or she were the plan participant. Thus, in one case, the court held that the ex-wife's interest in her ex-husband's pension was excluded from her bankruptcy estate.[40]

New York law specifically provides that the provisions exempting retirement plans from claims of creditors do not impair rights under a QDRO or an order of support, alimony or maintenance.[41]

## IRAs

IRAs (including employer-sponsored IRAs such as SEPs and SIMPLE IRAs) are not subject to the ERISA anti-alienation rule,[42] nor are they subject to the anti-alienation rules under the Code (because they are not qualified plans). Any protection against creditors, including judgment creditors, must be based on state law.[43]

## Federal Tax Issues

The current position of IRS is that a debtor's interest in a qualified plan, and similar interests, are property of the bankruptcy estate, but only for the benefit of IRS.[44]

In field service advice, IRS has stated that a plan may refuse to honor an IRS tax levy if the participant is not currently entitled to a distribution. [45] However, according to a later Chief Counsel Advice, IRS may elect a distribution, on behalf of the participant, if he or she has a present right to a distribution.[46]

The 10 percent additional income tax on early distributions, under Code section 72(t), does not apply to distributions made on account of an IRS levy on a qualified plan, 403(b) plan or IRA.[47] The exception applies to distributions after 1999, and does not apply unless there is an actual levy. There is no statutory exception for distributions to a bankrupt participant.[48]

In *Mounier*,[49] the court held that the 72(t) tax is not dischargeable in bankruptcy.

In *Berry*,[50] the court held that the debtor's interest in a city's retirement plan is part of his bankruptcy estate, and subject to the IRS' secured claim for unpaid taxes.

## Additional Issues

### What if the Debtor Is also the Plan Sponsor?

In *New Center Hospital*,[51] the debtor was the plan sponsor and plan administrator. The court held that the bankruptcy trustee could not abandon the plan, became plan administrator by operation of law, and was required to carry out the plan administrator's duties.[52]

### Benefits That Have Already Been Distributed by the Plan

In *Guidry*,[53] the 10th Circuit, sitting *en banc*, allowed the garnishment of funds held in a separate bank account that had been established to hold only benefit payments from a qualified plan.

### Bankruptcy Reform

The Senate has passed the Bankruptcy Reform Act of 2001 (S. 420) and the House has passed its bill, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2001 (H.R. 433). The pension provisions of the bills are as follows:

1. The bills provide an exemption from the bankruptcy estate for any retirement funds that are held in a trust or account that is tax-exempt under Code section 401, 403, 408, 408A, 414, 457 or 501(a).[54]

2. If the plan has received a favorable determination letter from the IRS, and that letter is still in effect on the date of commencement of bankruptcy proceedings, then the retirement funds would be presumed to be exempt. If the plan has not received a determination

letter, the funds would be exempt if the debtor establishes that

(a) No prior determination to the contrary has been made by IRS or a court; and

(b)(i) The plan is in "substantial compliance" with the applicable requirements of the Code; or

(b)(ii) The debtor is not "materially responsible" for the plan's failure to be in substantial compliance.[55]

3. Any direct transfer of retirement funds from one plan to another will not cease to be exempt by reason of the transfer.[56]

4. Any eligible rollover distribution will not cease to be exempt by reason of the transfer.[57]

5. Participant loan repayments would continue to be withheld during bankruptcy proceedings, and any amount owed to the plan would not be a dischargeable debt.[58] Amounts required to repay the loan would not constitute disposable income under chapter 13.[59]

6. For an IRA or Roth IRA, but not a SEP or SIMPLE IRA, the exemption would be limited to $1 million (indexed), although the amount may be increased if "the interests of justice so require." Amounts attributable to rollovers from employer plans would not count toward the $1 million cap.[60]

7. Participant contributions to a pension or health plan would be exempt from the debtor's bankruptcy estate and would not be disposable income under chapter 13.[61]

The prospects of enactment are doubtful. On June 19, 2001, Senate Majority Leader Daschle told reporters that he might appoint conferees to reconcile the House and Senate bills. The Senate bill includes consumer protections that are not in the House bill, and Daschle accused Republicans of "trying to hide behind" their insistence that the Senate take up the House version. On June 7, 2001, House Majority Leader Armey said that the House could not take up the Senate bill.[62]

## Endnotes

1. For more detailed discussions of these issues see, for instance, Alston R. Martin, *Creditors' and Debtors' Rights in Retirement Benefits: Developments in the Post-Patterson v. Shumate Era*, ALI-ABA Course of Study Materials, Representing Professional and Personal Service Corporations: Qualified Plans, Other Employee Benefits, Taxation, Insurance, and Health Care, vol. II, Feb., 2001, Course No. SF69; Mark P. Altieri & Richard A. Naegele, *Creditors' Rights, Tax-Qualified Plans and IRAs*, 26 J. of Pension Planning & Compliance (no. 4) 13 (2001); Patricia Dilley, *Hidden in Plain View: The Pension Shield Against Creditors*, 74 Ind. L. J. 355 (1999); Donna Litman, *Bankruptcy Status of "ERISA Qualified Pension Plans"—An Epilogue to Patterson v. Shumate*, 9 Am. Bankr. Inst. L. Rev. 637 (2001).
2. *See, e.g*, Pamela D. Perdue, *Bankruptcy and Qualified Plans*, ALI-ABA Course of Study Materials, Fundamentals of Employee Benefits Law, vol. II, Mar. 2001, Course No. SF73; Gary M. Ford and Lincoln Weed, *Bankruptcy and Defined Benefit Pension Plans*, ALI-ABA Course of Study Materials, Employee Benefits Litigation, vol. II, May 2001, Course No. SF83.
3. I.R.C. § 401(a)(13); ERISA § 206(d). There are several exceptions, the most important of which allow (i) QDROS, (ii) a security interest in the accrued benefit to secure repayment of a plan loan, and (iii) the offset of the accrued benefit against certain judgments or settlements.
4. I.R.C. § 401(a), final paragraph.
5. ERISA § 4(b); 29 C.F.R. § 2510.3-3(b). Thus, a plan that covers only self-employed individuals or corporate shareholders and (in each case) their spouses is not subject to ERISA.
6. ERISA § 201(6).
7. ERISA § 201(2) and (4) exempt unfunded top hat plans and excess plans (funded or unfunded). For this purpose, a rabbi trust does not constitute funding. *See also* Michael J. Canan & Russell Hamilton III, *Employer-Sponsored Nonqualified Deferred Compensation Arrangements and Claims of Participants' Creditors*, 19 J. of Pension Planning & Compliance 5 (1994).
8. The Bankruptcy Code is Title 11 of the U.S. Code.
9. *Patterson v. Shumate*, 504 U.S. 753 (1992).
10. *See* Charles Edward Falk, *Patterson v. Shumate: A Five-Year Legacy*, 25 Tax Mgmt. Comp. Plan. J. 143 (July 4, 1997); Joseph S. Adams & Karen A. Simonsen, *Patterson v. Shumate & Keogh Plans: Should the Retirement Plan Assets of a Self-Employed Individual Be Included in the Individual's Bankruptcy Estate?*, 23 Tax Mgmt. Comp. Plan. J. 123 (May 5, 1995).
11. I.R.C. §§ 401 *et seq.*
12. *In re Witwer*, 148 B.R. 930 (Bankr., C. D. Cal., 1992), *aff'd*, 163 B.R. 614 (9th Cir., 1994).
13. *See, e.g., In re Watson*, 214 BR 597 (Bankr., 9th Cir., 1997); *In re Baker*, 21 EBC 1124 (7th Cir., 1997); *Bernstein v. Greenpoint Savings Bank*, 149 B.R. 760 (E.D.N.Y. 1993) (Keogh plans not exempt where self-employed dentist had always been the only participant); *Traina v. Sewell*, 1998 WL 915862 (E.D. La. 1998), *aff'd,* 180 F.3d 707 (5th Cir. 1999); I*n re Craig*, 204 B.R. 756 (D. N.D. 1997) (plan was not amended to comply with law changes; court held that plan need only be subject to ERISA and contain an anti-alienation provision—it need not be qualified); *In re Hanes*, 162 B.R. 733 (Bankr., E.D. Va. 1994);

*In re Reuter*, 11 F.3d 850 (9th Cir. 1993); *In re Bennett*, 185 B.R. 4 (E.D.N.Y. 1995); *S.E.C. v. Johnston*, 922 F. Supp. 1220 (E.D. Mich. 1996); *In re Meinen*, 228 B.R. 368 (Bankr., W.D. Pa. 1998).

14. *Traina,* note 13 *supra; In re Baker*, 114 F.3d 636 (7th Cir. 1996); *contra*, *In re Fernandez*, 236 BR 483 (Bankr., M.D. Fla. 1999) (holding that, if the court found that the plan was not operated in accordance with ERISA, the exclusion could be lost).
15. *See also In re Connor*, 73 F.3d 258 (7th Cir. 1996).
16. Cases that have taken this position include *In re Hall*, 151 B.R. 412 (Bankr., W.D. Mich. 1993); *In re Lane*, 149 B.R. 760 (Bankr., E.D.N.Y. 1993); *In re Witwer,* note 12 *supra*; *In re Sirois*, 144 B.R. 12 (Bankr., D. Mass. 1992); *In re Crosby*, 162 B.R. 276 (Bankr., C.D. Cal. 1993); *In re Blais*, 1994 Bankr. LEXIS 1427 (Bankr., S.D. Fl., 1994) (fact that plan previously covered employees was irrelevant); *In re Foy*, 164 B.R. 595 (Bankr., S.D. Ohio, 1994).
17. *Dzikowski v. Blau*, 220 BR 484 (S.D. Fla., 1998). *See also Hall,* note 16 *supra; Lane,* note 16 *supra*; *In re Lawrence*, 235 BR 498 (Bankr., S.D. Fla., 1999); *Blais,* note 16 *supra*.
18. *See, e.g., In re Youngblood*, 29 F.3d 225 (5th Cir., 1993).
19. *In re Moses*, 215 BR 27 (Bankr., 9th Cir., 1997).
20. John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law*, 3rd ed. (Foundation Press, 2000) at 639; *In re Watkins*, 95 Bankr. 483 (W.D. Mich., 1988); *In re West*, 81 Bankr. 22 (Bankr., 9th Cir., 1987).
21. *See, e.g., In re Kincaid*, 917 F.2d 1162 (9th Cir. 1990); *Morter v. Farm Credit Services*, 937 F.2d 354 (7th Cir. 1991).
22. *See, e.g., In re Harline*, 950 F.2d 669 (10th Cir. 1991); *In re Crosby*, 162 Bankr. 276 (Bankr., C.D. Cal., 1993); *Moses,* note 19 *supra* (as one of 2,500 partners, debtor did not have control, so exemption applied); *In re Lane,* note 16 *supra*.
23. FSA 1999632. *See also In re Atwood*, 259 B.R. 158 (Bankr., 9th Cir., 2001) (governmental 457 plan).
24. 5 U.S.C. § 8346(a).
25. *Whetzal v. Alderson*, 32 F.3d 1302 (8th Cir. 1994).
26. *See* Treas. Reg. 1.401(a)-13(b)(2); *Anderson v. U.S.*, 149 Bankr. 591 (Bankr., 9th Cir. 1992).
27. For a discussion of state exemption statutes, see *Martin*, note 1, *supra*.
28. Debtor and Creditor Law, § 282.
29. CPLR 5205(c)-2.
30. CPLR 5205(c)-2, 5205(c)-3; *see also* EPTL 7-3.1(b)(1), (2) (which does not refer to 457 plans).
31. CPLR 5205(c)-5; *see also* EPTL 7-3.1(b)(4).
32. Debtor and Creditor Law, § 282(2). The plan does not have to be "qualified" under any section of the Code in order for the debtor to exempt his or her interest (*In re Bentley*, 237 BR 10, 1997). *See also In re Dubroff*, 119 F.3d 75 (2nd Cir. 1997); *In re Lowe*, 252 BR 614 (2000); *In re Hunt*, 250 BR 482 (2000). A city-sponsored deferred compensation plan is a "similar plan or contract" so the debtor can claim his interest as exempt (*In re Ruffo*, 261 BR 580, 2001).
33. *See, e.g., In re Villarie*, 648 F.2d 810 (2nd Cir. 1981).
34. *See, e.g., In re Harshbarger*, 66 F.3d 775 (6th Cir. 1995); *In re Delnero*, 191 BR 539 (Bankr., N.D.N.Y., 1996); *In re Estes*, 254 BR 261 (Bankr., D. Id., 2000).
35. *Martin*, note 1 *supra*, citing *In re Carpenter*, 23 BR 318 (Bankr., D. N.J. 1982).
36. *In re Stones*, 157 Bankr. 669 (S.D. Cal. 1993).
37. *In re Taylor*, 243 F.3d 124 (2nd Cir. 2001).
38. *In re Gendreau*, 122 F.3d 815 (9th Cir. 1997), *cert. denied*, 118 S. Ct. 1187 (1998).
39. *In re Lowenschuss*, 170 F.3d 923 (9th Cir. 1999).
40. *McDonald v. Metz*, 225 BR 173 (Bankr., 9th Cir. 1998). *See also In re Nelson* (Bankr., 8th Cir., March 21, 2002, No. 01-6072 MN).
41. CPLR 5205(c)-4; EPTL 7-3.1(b)(3).
42. ERISA § 201(6).
43. The Investment Company Institute has compiled a survey of the extent to which IRAs are protected in bankruptcy under the laws of each state. The most recent (1999) survey is available at <http://www.ici.org/retirement/99_state_ira_bnkrptcy.html>. *See also* Altieri & Naegele, note 1 *supra*, "State-by-State Analysis of IRAs as Exempt Property," at 23–30.
44. CCA 200041029; *see also In re Lyons*, 178 BR 88 (Bankr., D. D.C. 1992).
45. FSA 199930039.
46. CCA 199936042.
47. I.R.C. § 72(t)(2)(A)(vii).
48. *See also In re Kochell*, 804 F.2d 84 (7th Cir. 1986), decided under a prior version of the tax. Before the debtor attained age 59½, the trustee in bankruptcy withdrew funds from an IRA. The court held that the tax applied.
49. *In re Mounier*, 98-2 USTC (CCH) 50,833 (Bankr. Ct., S.D. Cal. 1998).
50. *In re Berry*, 268 B.R. 819 (E.D. Tenn., 2001).
51. *In re New Center Hospital*, 200 B.R. 592, 20 EBC 1869 (E.D. Mich., 1996).
52. This situation is addressed in section 420 of S. 420, the Senate version of the pending bankruptcy reform legislation. There is no corresponding provision in the House bill.
53. *Guidry v. Sheet Metal Workers' National Pension Fund*, 39 F.3d 1078 (10th Cir. 1994); *see also Trucking Employees of North Jersey Welfare Fund., Inc. v. Colville*, 16 F.3d 52 (3rd Cir. 1994).
54. Section 224(a)(1) of H.R. 333, amending section 522(b) of the Bankruptcy Code. Except where specifically otherwise noted below, the equivalent sections of S. 420 effect the same changes.
55. *Id.*
56. *Id.*
57. *Id.*
58. Section 224(b), (c) of H.R. 333, amending sections 522(d) and 523(a) of the Bankruptcy Code.
59. Section 224(d) of H.R. 333, amending section 1322 of the Bankruptcy Code.
60. Section 224(e) of H.R. 333, adding new section 522(n) to the Bankruptcy Code.
61. Section 323 of H.R. 333, and section 322 of S. 420, adding new section 541(b)(7) to the Bankruptcy Code.
62. Adam Wasch, *Bankruptcy Reform: Daschle Faces Down Wellstone Filibuster, 'Blue-Slip' Threats to Bankruptcy Measure*, Bankruptcy Law Daily (BNA) June 20, 2001.

**David A. Pratt is the Chair of this Section's Committee on Life Insurance and Employee Benefits and a Professor of Law at Albany Law School.**

# Of Murder (and Estates and Trusts), She Wrote

By John G. Grall

Ah, the summer vacation (or weekend, at least). A sunny beach, a refreshingly cool beverage, an absorbing book to leisurely read.

But what tomes to tackle this summer? Perhaps you've wearied of family and friends teasing you without consideration or mercy for sneaking 17 volumes of *Scott on Trusts* into your beach bag. And yet, the prospect of joining the unwashed millions herded into reading the book of the movie they've just seen is unappealing.

Here's a suggestion for your summer reading list that may allow you to incorporate professional interests without being revealed as a tedious grind to those who love but misunderstand you.

During the last 20 years of her life, before she died in January 2000, Sarah Caudwell wrote four laugh-out-loud murder mysteries that drew heavily on her background as a London barrister and member of the legal section of Lloyds Bank Trust Division. A delightful intermixing of the laws of taxation and homicide, the volumes turn the intricacies of tax planning (a subject taken deathly seriously across the pond) into hilarious high camp. For summer reading, the books are all available as compact travel-friendly paperbacks graced by Edward Gorey's quirky cover illustrations.

But don't read Caudwell for the discretionary trusts and tails in fee. Instead, read Caudwell for her characters, who are a charming collection of acerbic barristers practicing law with wit and humor at 62 New Square, London, and their faux-pompous Oxford law don, Hilary Tamar.

In *Thus Was Adonis Murdered*, the continuing cast of lawyer sleuths is introduced, engaged in unraveling the puzzling circumstances surrounding a death in Venice in which tax barrister Julia Larwood is rather too involved, as prime suspect. Accused of committing the murder of a revenue agent during her own summer holiday, hapless helpless Julia fits well the annoying (to tax attorneys) stereotype of talented tax attorney utterly unable to negotiate normal adult life. As Professor Tamar explains, "She must have been, no doubt, a docile, good-natured child, with a certain facility for Latin verbs and intelligence tests—but what use is that to anyone? Seeking some suitable refuge, where her inadequacies would pass unnoticed, her relatives, very sensibly, sent her to Lincoln's Inn." I imagine Lincoln's Inn to be the U.K. equivalent of Harvard Law.

Julia has flown to Venice hoping to forget for a time her own unhappy troubles with the Inland Revenue,

> due to her own omission, during four years of modestly successful practice at the Bar, to pay any income tax. The truth is that she did not, in her heart of hearts, really believe in income tax. It was a subject which she had studied for examinations and on which she had thereafter advised a number of clients. She naturally did not suppose, in these circumstances, that it had anything to do with real life. The day had come on which the Revenue discovered her existence, and reminded her of theirs.

In Venice in flight from the Revenue and doggedly "after a bit of the other," Julia finds a suitably handsome young man among her fellow travelers and, as is the way in such matters, her real troubles begin. Julia's Adonis (real name Ned) is a Revenue agent. Early on, after Ned is found stabbed to death in bed, his profession as tax gatherer is seen as helpful to extricating Julia from the suspicions of the Venetian police. After all, a man from the Revenue might be murdered by anyone. But when Julia's inscribed copy of this year's Finance Act is found lying a few feet from the bloody corpse, there is much explaining to be done.

Julia Larwood, and indeed all Caudwell's characters, arguably are constructed of one-dimensional cardboard revealed only superficially through witty dialogue and letter-writing. But there's no taking away from the fact that the simply drawn barristers are very funny in the best tradition of British comic writing, even if not especially real. Suspend disbelief. You'll have fun.

An attorney acquainted with matters of probate and descent and distribution may feel most at home in Caudwell's second book, *The Shortest Way to Hades*, which comes complete with a well-constructed family tree suitable for filing in surrogate's court. In fact, much of the background information on which the book depends is set forth verbatim from documents filed by the New Square barristers in a case under the Variation of Trusts Act. In a ruthlessly concise affidavit, we're efficiently acquainted with the Remington-Fiske family and fortune, consisting

primarily of a mammoth land trust set to be enjoyed eventually in traditional British "winner take all" fashion by a single heir. As barrister Selena Jardine explains,

> it is the dearest hope of the English landowner to father an unbroken line of male offspring, all large and red-faced and fond of hunting. But when making his Will he has to contemplate the possibility of an elder son dying, leaving only daughters, and to decide whether, in that regrettable event, his property should pass into the incompetent hands of a daughter or to some person of the preferred sex in a junior branch of the family.

In his 1934 Will, Sir James Remington-Fiske has taken the "really rather progressive view" that an elder female ought to take precedence over a junior male, but maintains the tradition that the eldest heir (of either gender) shall take the entire trust corpus. After a reformation of the testamentary trust designed to save substantial capital transfer tax, the five-million-pounds trust remainder appears headed exclusively to granddaughter Camilla. All the agreeable grandchildren of both sexes and disparate parentage appear content. But then, as the elderly and ailing life tenant is poised to pass on, dreary adult grandchild Dierdre is tossed from a parapet and dies during an otherwise cozy family gathering. In the way of murder mysteries, the death may or may not be homicide. No one in the family seems inclined to think it is homicide. And the vexing problem is, the perhaps-murdered grandchild is not the obvious target Camilla, but rather the second-in-line to riches. But as Selena points out, "a person murderously resolved to secure possession of the Remington-Fiske estates, being more remote in the succession than both Deirdre and Camilla, would not necessarily have disposed of them in order of seniority." And sure enough, Camilla soon nearly succumbs to drowning during a sailing accident. One begins to refer anxiously to the family tree. But enough about the plot. Anything more, and you may not read the book.

In Caudwell's third book, *The Sirens Sang of Murder*, the central plot device is a type of discretionary trust useful decades ago to avoid U.K. income tax. Foreign discretionary trusts sited outside the United Kingdom are described by Caudwell as so entirely discretionary that the trustees may distribute trust property to literally anyone the trustees decide. The trusts were very murky and secretive, with not even the true settlor identified in the establishing document. The settlor's distributive directions were recorded separately and informally by letter of wishes. The only beneficiaries named in the trust document were those selected to receive the trust property remaining at the expiration of the trust term, who typically received nothing, the settlor's informal instructions exhausting the corpus long beforehand. Indeed, the named remainder beneficiary often was a Revenue agent, as a sort of dry joke. In *Sirens*, the embarrassed trustees of a discretionary trust called the Daffodil Settlement (engorged over the years by "beautiful capital gains") have lost track of the intended beneficiaries of a nine-million-pound fund. The frightened trustees retain New Square barrister Michael Cantrip to instruct them what to do. Michael is soon jetting off to tax havens Jersey and Sark, and then across France to Monte Carlo, accompanied by the usual colorful Caudwellian cast and burdened by the apparently homicidal attentions of an "off his onion" chancery judge. The book is especially delightful to anyone who (alas, like myself when a misguided youth) has labored for a time in international tax planning. A delightful recurring vehicle in *The Sirens* is excepts from the perhaps-fictional *Guide to Comfortable Tax Planning*, described by Caudwell as a collection of the advice of certain members of the U.K. tax bar for the benefit of no one but themselves,

> which contains such invaluable advice on such questions as where to stay in Vaduz, eat in Gibraltar, or buy a novel in the British Virgin Islands, which flights to Luxembourg offer free champagne, what to see in Nassau, do in Vanuatu, wear in Panama, drink in the Netherlands Antilles, and on no account do in the Turks and Caicos.

In *The Sibyl in Her Grave*, her final work published in 2000, Caudwell takes on the very modern concerns of capital gains taxes and insider trading. Julia's Aunt Regina, resident of quaint village Parsons Haver, has pooled modest resources with friends to invest in equities. Supernaturally successful, Aunt Regina and her investments club have been guided to riches by insider trading tips passed off as clairvoyance by psychic friend Isabella del Comino, recently moved into the village rectory with an aviary of ravens. *Sibyl* is an intelligent send-up of the classic English village murder mystery genre, complete with a tippling vicar and mad virgin. Having previously advised her aunt on the legal niceties of establishing a testamentary trust for the benefit of a pet tortoise (the U.K. equivalent of an EPTL 7-6.1 trust?),[1] Julia and the New Square barristers are implored initially to puzzle out how to deal with the very practical problem of paying capital gains tax

after the capital is improvidently spent. But soon there's a body in the aviary and, well, ravens are omnivores. The plot is outrageous, and outrageously funny. I'll reveal no more.

* * *

I have acquaintances who have read all four Sarah Caudwell mysteries without ever having realized that never in any of the books is Professor Hilary Tamar's gender revealed. There's very intentionally no physical description of the Oxford don whatever. Mystery fanatics claim the erudite Professor Tamar is him(or her) -self Sarah Caudwell's greatest mystery.

One friend offers that she's always assumed Professor Tamar is a man, because "he" is forever coming off as pompous in a scholarly "let me explain it to you" way. "You know the type," says my friend. Yes, I do.

Another friend explains he's always thought of Hilary Tamar as a woman, because of "her" attention to detail and understanding of human failings and motivations, but over-willingness to imagine fantastic intrigue. "You know the type," this friend explains. Well, yes, I do.

Interesting.

Although Caudwell may be criticized for spinning characters too typical, in Professor Tamar she has created a very atypical mystery figure onto whom the reader is forced to project her or his own revealing stereotypes.

All in jolly good fun.

## Endnote

1. Consider for a moment the unfortunate fate of a *New York* tortoise (or other long-lived animal trust beneficiary, such as the miniature horse or parrot), who it seems to me might often outlive the termination provisions of EPTL 7-6.1(a). I understand there are arcane Rule Against Perpetuities principles somehow at stake, but can nothing be done? Miniature horses can become quite nasty when provoked. A matter for the Committee on Legislation perhaps?

**John G. Grall is with Levene Gouldin & Thompson, LLP, of Binghamton and Vestal, New York.**

Weiser

M.R.Weiser & Co.LLP
Certified Public Accountants
and Consultants

**New York**
135 West 50th Street
New York, NY 10020
Tel 212.812.7000
Fax 212.375.6888

3000 Marcus Avenue
Lake Success, NY 11042
Tel 516.488.1200
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# Common Preparer Errors on Form 706

During the auditing process of estate tax returns, an IRS report found three common errors. Lack of knowledge regarding the change in tax laws appears to be a key element in many of the preparer errors. The three errors are:

1. **Using incorrect unified credit.** This error is due to form changes that stem from the changing tax laws. Some preparers use a version of the Form 706 that does not correctly correspond to the decedent's year of death. Currently, this error seems to be committed most commonly for estates of decedents who died in 2000 and 2001.

2. **Qualified family owned business interest deduction (QFOBI).** This deduction and the applicable credit must not exceed $1,300,000. In cases where the preparer claims a unified credit that is too small due to an incorrect version of the Form 706, the QFOBI deduction, if claimed, is too large. This deduction will be eliminated for estates of decedents who die after December 31, 2003.

3. **No date-of-death values.** Occasionally, when alternate valuation is elected, the preparer will only include that valuation amount and not the date-of-death amounts. This error usually occurs because the preparer was not aware that that date-of-death amount was to be included or incorrectly identified date-of-death amount as alternate valuation amount. When using alternate valuation, the date-of-death amount must be included so that the correct estate liability can be verified. The alternate valuation gross estate must be less than the date-of-death gross estate. The IRS cannot determine that if both values are not disclosed.

*This information from the IRS report was provided to the* Newsletter *by John Rausch from the Internal Revenue Service.*

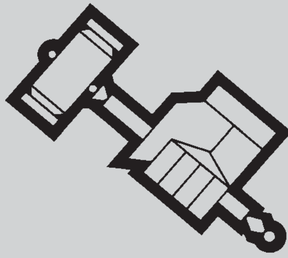
## IRS Contact Information

With the centralization of filing the estate and gift tax returns, the IRS has established contact information for each Territory. New York and New England are in Territory One.

The information for the clerical manager is:

**Barbara Courtney** Tel: (859) 669-2219
Fax: (859) 669-3004

IRS Estate and Gift Tax Stop 824-G
301 W. Rivercenter Blvd.
Covington, KY 41019



# RECENT NEW YORK STATE DECISIONS

John C. Welsh

## WILLS

### PROBATE—MISTAKE OF FACT OR LAW

Testatrix' will left her entire estate to her adult son, A, to the exclusion of a mentally disabled son, B, and three children of a deceased daughter. B claimed that he had been excluded from benefits by undue influence exerted by A and by his mother's belief that testamentary gifts to B would adversely affect his existing rights to social security benefits. A guardian was appointed to investigate B's allegations and he found no facts indicating any fraud, duress or undue influence. Nevertheless, the guardian requested a jury trial on behalf of B. The Surrogate dismissed the objections and admitted the will to probate. The Appellate Division found no abuse of discretion and affirmed the presumption of regularity applied to the execution ceremony since it was supervised by her attorney. Any possible misunderstanding held by testatrix as to the potential loss of social security benefits to B had no impact upon a clear, unambiguous will that reflected the intentions of testatrix. B had been a patient at a mental health facility for several years. *In re Young,* __ A.D.2d __, 738 N.Y.S.2d 100 (3d Dep't 2001).

### PROBATE—PROPER EXECUTION—COMPETENCY

The Appellate Division affirmed the dismissal of objections to probate on the grounds of improper execution, lack of testamentary capacity, fraud and undue influence. Although the attesting witnesses did not recall the execution ceremony, they identified their signatures on the will and the self-proving affidavit. The attorney supervising execution identified his signature on the self-proving affidavit and a presumption of regularity existed. Limited evidence supporting the other objections failed to raise an issue of fact. *In re Rosen,* __ A.D.2d __, 737 N.Y.S.2d 656 (2d Dep't 2002).

### PROBATE—TESTAMENTARY CAPACITY

The Appellate Division affirmed a directed verdict of the Surrogate admitting decedent's will to probate. Objectants failed to raise a question of fact concerning testamentary capacity. The neurological expert was unable to find incapacity with a reasonable degree of medical certainty. Testimony that decedent had been diagnosed as suffering from Alzheimer's disease was hearsay and properly excluded. Notes offered to prove that the testator was delusional were properly excluded since they were undated and their authenticity not proven. *In re Will of Brownstone,* 289 A.D.2d 97, 735 N.Y.S.2d 78 (1st Dep't 2001).

### PROBATE

The Appellate Division found that the Surrogate erred in failing to grant summary judgment to the proponents admitting the testator's will to probate. The execution ceremony was supervised by an attorney, creating a presumption of regularity. No particularity of an alleged forgery was shown by objectants. Minimal proofs offered to show lack of testamentary capacity and undue influence were insufficient to raise a question of fact. *In re Herman,* 289 A.D.2d 239, 734 N.Y.S.2d 194 (2d Dep't 2001).

### AUTHORITY TO FILE OBJECTIONS

In an earlier decision, the Surrogate granted standing to an individual executor under a prior will to object to the probate of a later will. The executor satisfied the statutory requirement for showing good cause by making substantial factual assertions of undue influence and lack of testamentary capacity. The executor was not a beneficiary of the estate and was acting as a fiduciary for four charitable beneficiaries. Thereafter, the Attorney General appeared on behalf of the charities and sought to rescind the authority given to the executor named in the earlier will. The Surrogate agreed with the Attorney General and withdrew the authority to object. The court suggested that the most appropriate role for the denied objectant would be as a witness in the subsequent probate proceeding. *In re Baldwin,* 189 Misc. 2d 458, 733 N.Y.S.2d 831 (Sur. Ct., Fulton Co. 2001).

## ADMINISTRATION OF ESTATES

### HOMICIDE—FORFEITURE OF INHERITANCE

In 1998, H killed his wife, W, and then committed suicide. They left a joint will that provided that the entire estate of the first decedent would go to the survivor. Upon the death of the survivor, certain specific gifts were made with the residue to be divided into three equal shares for the benefit of H's parents, W's parents and the siblings of H and W. In the final distribution of the two estates, W's family sought to exclude H's family from taking since W's death was feloniously caused by H. The Court of Appeals ruled unanimously that any gifts to H from W were void under the long-standing rule of *Riggs v. Palmer*. However, the family of H, all innocent parties, continued to take their shares as described in the joint will. Assets held by H and W as joint tenants were divided equally between the two estates. Proceeds from life insurance policies and a retirement fund were payable to H's parents as alternate beneficiaries who were not disqualified. *In re Estates of Covert*, 97 N.Y.2d 68, 761 N.E.2d 571, 735 N.Y.S.2d 879 (2001).

### WRONGFUL DEATH—RENUNCIATION

Decedent died as a result of a motorcycle-car collision and was survived by the mother and sister. He had named his sister as the beneficiary of his life insurance policies and his pension plan as well as fully supporting her during his lifetime. The sister was appointed administratrix of decedent's estate and commenced a wrongful death action and a suit for conscious pain and suffering against the owner and operator of the automobile. Decedent's mother then renounced her interest in the estate as sole distributee in favor of his sister. The Appellate Division ruled that the renunciation substituted the damages suffered by the sister for the damages suffered by the mother, the applicable measure without the renunciation. Under EPTL 2-1.11, the effect of the renunciation was to treat the mother as predeceasing her son. Her damages then became irrelevant. It appeared that the damages provable by the sister would greatly exceed those provable by the mother. *DeLuca v. Gallo*, __ A.D.2d __, 735 N.Y.S.2d 596 (2d Dep't 2001).

### DISCOVERY PROCEEDING—INDEMNIFICATION

N entered into a purchase and sale contract with plaintiff in 1990. G was appointed guardian of N's person and property in 1993 and served for two years until N's death. G was appointed executrix of N's estate pursuant to N's will. Plaintiff brought an action for indemnification against G based on a suit brought against him by G on N's behalf alleging misrepresentation and breach of fiduciary duty. The Appellate Division agreed that G's action was brought in her fiduciary capacity and could not be the basis of personal liability. *Skolnick v. Goldberg*, __ A.D.2d __, 737 N.Y.S.3d 601 (1st Dep't 2002).

### RIGHT TO FUNDS DEPOSITED WITH COMPTROLLER

One day before her death, testatrix executed her will leaving her entire estate to a friend. At the probate proceeding, there were no known distributees. Notice was given to the Attorney General and the Public Administrator. The unknown distributees were served by publication. In a compromise agreement, no objection to probate was raised and $13,000 (13 percent of the net estate) was deposited with the Comptroller. After the passage of 17 years with no distributee coming forward, the sole legatee claimed the fund on deposit. The Surrogate denied the application of the legatee and ruled that SCPA 2225, allowing distribution when a class of distributees may not be fully identified, should not be broadened for the benefit of the claimant. *In re Plongeron*, 189 Misc. 2d 561, 734 N.Y.S.2d 418 (Sur. Ct., N.Y. Co. 2001).

## TRUSTS

### CONSTRUCTION—CAPITAL GAINS NOT PART OF NET INCOME

Settlor created a revocable *inter vivos* trust with a corporate trustee to pay the income to himself for life together with so much of the principal as the trustee deemed advisable to provide for the settlor's "support, maintenance, welfare and comfort." Following the settlor's death, the trust was to continue for the benefit of his surviving siblings, nieces and nephews. Annual distributions were to be made of the "net income as determined under the laws of the United States." Upon the death of the last income beneficiary, the trust was to continue as a perpetual charitable trust with net income paid to designated charities. The trustee was allowed to settle its accounts by agreement with existing beneficiaries and such agreements were binding on future beneficiaries. In the year after the creation of the trust, the settlor agreed to a substitution of corporate trustees without any accounting. Eight years after the death of the settlor, the secondary income beneficiaries sought an accounting and a declaration that capital gains were to be included in the income distributions. The Appellate Division agreed with the Supreme Court determination that settlor wanted "net income" to be determined according to the Internal Revenue Code which by regulation excluded capital gains from distributable net income and found them not distrib-

utable to income beneficiaries unless local law was to the contrary. With the trust instrument silent, New York law allocates capital gains to principal. This result is consistent with settlor's apparent intent to perpetuate maximum income distribution through three tiers of beneficiaries. The appropriate accounting period began with the death of the settlor. The settlor of a revocable trust had the right to excuse the trustee from accounting to anyone other than himself while his right to revoke continued. *Andrews v. Trustco Bank*, 289 A.D.2d 910, 735 N.Y.S.2d 640 (3d Dep't 2001).

### ACCOUNTING—RIGHT TO OBJECT

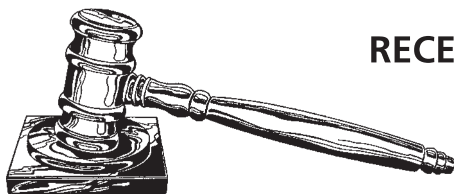
In 1994, A and B created a joint revocable living trust naming themselves as trustees. When A died in 1995, C succeeded him as trustee. Both B and C resigned as trustees in 1998. Three children of A's first marriage objected to the accountings for the periods prior to and subsequent to A's death. The Appellate Division agreed with B's position that only A and B had an interest in the trust during their joint lives. Since the interest of A's children in the trust did not ripen until A's death when the trust became irrevocable, they had no standing to file objections to an accounting for the period ending at A's death. Any ambiguity in the trust provisions did not relate to this issue. However, the objections interposed by A's children as to the later period were properly asserted. Although they were clearly beneficiaries during that period, B opposed any standing to file because the trust limited the obligation of the trustees to account to only "a majority of the income beneficiaries who are then sui juris." Since B was the only person within that class, the terms of the provision would exclude A's children from objecting. The Appellate Division held that this was an attempt to exclude completely the obligation of the trustee to account. As such, it was a violation of public policy and not enforceable. *In re Malaskey,* __ A.D.2d __, 736 N.Y.S.2d 151 (3d Dep't 2002).

### INVESTMENT POLICY OF TRUSTEE

In 1966, testator's will created a trust for the benefit of her daughter to whom income and some principal were paid for the next 32 years. Upon her death, the remainderman objected to the investment policy of the corporate trustee in selling its own stock and keeping the corpus investment in its common trust fund. The amount for distribution was almost doubled in value from the time the trust was created. The Appellate Division found that the liquidation of the trustee's own stock in favor of investment in its common trust fund was proper diversification as required by the "prudent person" rule. Permission to retain existing stock granted to the trustee by the will did not remove the need to diversify. Questions of approval and notification of intermediate accountings were resolved in favor of the trustee. *In re Strong,* 289 A.D.2d 798, 734 N.Y.S.2d 668 (3d Dep't 2001).

### EXERCISE OF POWER OF APPOINTMENT

A trust creating a general testamentary power of appointment with a gift in default of appointment required that exercise be limited to a will specifically referring to the power. The donee of the power died leaving a will purporting to transfer any trust assets "over which I may have a power of appointment, general or otherwise." The Appellate Division agreed with the Surrogate that the broad reference in the will to the power was ineffective to create an exercise. The language chosen by the testator was controlling, not his intent. *In re Shenkman,* __ A.D.2d __, 737 N.Y.S.2d 39 (1st Dep't 2002).



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

**Ilene Sherwyn Cooper and Donald S. Klein**

## Attorney's Fees

In an application for legal fees, the court was requested to fix the compensation of an attorney for the legatees under the decedent's will for services rendered in connection with the administration of her estate, the probate contest related to her will, and the establishment of a "dog trust" thereunder for the benefit of the decedent's dogs. Objections to the fee request were filed by the executor and residuary beneficiary of the estate, who claimed that other than those services rendered in connection with the "dog trust," the work performed did not benefit the estate, and were performed voluntarily.

The court determined that counsel's services in connection with the probate contest were unquestionably beneficial to the estate. However, where services are rendered on behalf of a party, albeit a necessary party, who lacks standing to object to probate, such services are rendered voluntarily and are not compensable from the estate, except to the extent that such services are rendered in connection with the appointment of the estate fiduciary. Accordingly, the court awarded counsel fees in the sum of $105,000, rather than the $600,000 requested. *In re Estate of Doris Duke*, N.Y.L.J., Jan. 9, 2002, p. 18 (Sur. Ct., N.Y. Co.) (Preminger, Sur.).

## Construction of Will

In a proceeding for construction of the decedent's will, the court was asked to determine to whom the remainder interest in the trust was distributable. Under the terms of the will, the trustee was directed to pay the net annual income to the testator's wife during her lifetime, and upon her death, the remaining principal to the testator's daughter. The testator's daughter predeceased his wife by almost five years, leaving a will which bequeathed her estate to her husband.

The court held that the language of the will clearly expressed testator's intent to give his daughter a present gift, the enjoyment of which was postponed until the death of his wife. The absence of a gift over or words requiring survivorship was indicative of an intent that the remainder should vest absolutely. Identification of the remainder beneficiary by name and the use of words of present gift in disposing of the remainder were clear manifestations of the testator's intent to vest the remainder immediately upon his death.

Accordingly, the court determined that the remainder interest of the decedent's daughter vested in her immediately upon the death of the testator and was not divested upon her death prior to the testator's wife. *In re Estate of William Holland*, N.Y.L.J., Feb. 26, 2002, p. 18 (Sur. Ct., N.Y. Co.) (Preminger, Sur.).

## Construction of Will

In a proceeding for construction of the decedent's will, the court was requested to determine the disposition of several charitable bequests, where the full name of the intended beneficiary was missing. Because the testator's choice of charity was ascertainable from a reading of the instrument, the court held that the doctrine of *cy pres* was inapplicable. Instead, the court held extrinsic evidence admissible to identify the charities, and utilized the affidavit of the attorney-draftsman to determine the complete name of the charitable recipients. *In re Estate of Paul Kay*, N.Y.L.J., Dec. 31, 2001, p. 24 (Sur. Ct., Nassau Co.) (Riordan, Sur.).

## Contempt Ordered

Petitioner, fiduciary, moved for an order vacating and setting aside a prior order of the court which, *inter alia,* directed him to account as attorney-in-fact and as administrator c.t.a. of the decedent's estate. In response, an Order to Show Cause was interposed seeking to hold the fiduciary in contempt.

The court denied the Petitioner's motion for vacatur, concluding that the Petitioner had exhausted all his appellate remedies with respect to the validity of the order to no avail.

Further, the court granted the application to hold the fiduciary in contempt. The court found the fiduciary's argument that he had not been served with a certified copy of the order directing him to account

to be an insufficient defense inasmuch as the record demonstrated that he had actual, personal knowledge of the order in issue. Additionally, the court found that the fiduciary had deliberately and knowingly disobeyed a clear judicial mandate, thereby impairing and prejudicing the rights of persons interested in the estate. The court noted that the estate remained insolvent, and unable to pay its obligations to creditors. *In re Estate of Nathan Morrison*, N.Y.L.J., Dec. 28, 2001, p. 23 (Sur. Ct., Westchester Co.) (Scarpino, Sur.).

### Fees of Guardian *ad Litem*

Submitted for decision was a request by the guardian *ad litem* for fees for services rendered on behalf of the unknown distributees of the decedent. The court noted that the affidavit of legal services of the guardian *ad litem* reported that work was performed by her as well as an associate of the firm in which the guardian was a partner. In this regard, the court set forth its expectation that an appointed guardian *ad litem* would rely solely upon his own skill and expertise, and not the expertise of an associate, in representing the ward's interests and filing a report. While clerical work may be assigned, substantive legal services on the case may not be without prior court approval. Services in the latter category, which are performed by other than the guardian *ad litem*, are not compensable.

Based upon the size of the estate, and a finding that the guardian *ad litem* independently performed her duties, the court awarded fees in the sum of $1,200. *In re Estate of William M. Kaborycha*, N.Y.L.J., Dec. 31, 2001, p. 24 (Sur. Ct., Nassau Co.) (Riordan, Sur.).

### Jurisdiction

Submitted to the court was an application requesting the court's consent to the transfer of an action from Supreme Court. Pending before the Supreme Court was an action brought in the name of the executrix against the movant, as Trustee of the pension and profit-sharing plans of the decedent's business.

Among other things, the will of the decedent disposed of shares of stock of the decedent's business, as well as the realty which housed the business, to the decedent's daughters and son-in-law. Allegations in the Supreme Court complaint included the contention that the decedent and/or his estate, was the principal beneficiary of the pension and profit-sharing plans, that an accounting with respect to distributions from the plans was demanded, and never obtained, and that the decedent's surviving spouse was the sole beneficiary of the amounts due under the plans.

The estate opposed the application to transfer the action on the grounds that it involved only non-probate assets, which would pass outside the estate, and that the dispute was one between living persons; to wit, the decedent's surviving spouse and the trustee of the plans. Nevertheless, the estate conceded that the outcome of the Supreme Court action might have an impact on the gross taxable estate of the decedent.

The court held that where the estate is not a claimant to the proceeds of a policy or plan, it may nevertheless be found that the Surrogate's Court has jurisdiction to determine the controversy between the parties, if the controversy has an impact on the estate. However, a small estate tax exposure where the proceeds of a plan are not payable to the estate is not an issue sufficiently related to the estate's administration so as to bring the matter under the court's jurisdiction. Accordingly, based on the record, the court found that the movant had not established that the Supreme Court action was a matter relating to the affairs of the decedent, and denied the application for its consent to a transfer of the matter without prejudice. *In re Estate of William F. Bindseil, Jr.*, N.Y.L.J., Feb. 28, 2002, p. 24 (Sur. Ct., Suffolk Co.) (Czygier, Sur.).

### Kinship

In an accounting proceeding, the claimants moved to reargue a decision of the court which found that an alleged non-marital child of the decedent was, in fact, a distributee. The court granted the motion, modified its prior decision and decree, and directed the surviving children of the decedent to conduct a diligent search for all possible marital and non-marital children of the decedent in order to sustain their request for a determination that they were the decedent's sole distributees entitled to his estate. *In re Estate of Eniola Adepoju Alao*, N.Y.L.J., Mar. 19, 2002, pp. 18, 20 (Sur. Ct., Kings Co.) (Feinberg, Sur.).

### Powers of Multiple Fiduciaries

In a contested proceeding between the trustees of a testamentary trust, two of the three trustees petitioned the court, *inter alia*, to compel the third trustee to consent to the transfer of trust assets to a new custodian, and to sign certain documents to facilitate that transfer. During the pendency of the motion, the Respondent claimed that she would cooperate in the transfer of the trust assets to a different custodian, but objected to the payment of legal fees out of the

trust, claiming that those fees were being incurred by the Petitioners to further their own individual interests.

In granting the relief requested by the Petitioners, the court acknowledged the authority of every fiduciary to employ attorneys to advise them, to defend their good faith discharge of their duties in office, and to pay any reasonable counsel fees he may necessarily incur. "Even legal services rendered in successfully defending a fiduciary against a variety of claims, including breach of fiduciary duty, are not necessarily chargeable to the fiduciary personally, although the services are arguably for the benefit of the fiduciary . . ."

Nevertheless, not all services performed by counsel on behalf of the fiduciary are compensable from the estate. The question turns upon the nature of the services performed. Thus, litigation "which advances the self-interest of the [fiduciary], which does not further the interest of the [estate or trust] itself, for instance, litigation to defend the entitlement to commissions, may justify the refusal to impose upon [an . . . estate or trust] the expense of the [fiduciary's] counsel fees . . ."

The fiduciary who pays counsel fees in advance of an accounting, or prior court approval, bears the risk of a surcharge to the extent that it is determined that assets subject to his stewardship were utilized for the fiduciary's personal needs. Inasmuch as the trustees were willing to assume such risk, the court concluded, under the circumstances, that they were entitled to retain counsel in their fiduciary capacities, and to pay reasonable attorney's fees out of the trust assets for those services, without prejudice to any future applications or positions taken by the fiduciaries or persons interested regarding the amount or propriety of the payment. *In re Estate of Frederic H. Williams*, N.Y.L.J., Jan. 10, 2002, p. 32 (Sur. Ct., Suffolk Co.) (Czygier, Sur.).

## Probate of Will—Due Execution

In an uncontested probate proceeding, issue was raised as to whether the testator and the attesting witnesses signed at the end of the instrument. Presented to the court was a seven-page document, with the first five pages numbered consecutively, and pages six and seven being in reverse order. The decedent signed her name in the margin of each page; page six (numbered page seven) contained the attestation clause and the names of the attesting witnesses, and page seven (numbered page six) contained two non-dispositive clauses as well as the name of the decedent, and the signatures of the three witnesses who signed on page seven following the attestation clause.

Two of the attesting witnesses submitted affidavits pursuant to SCPA 1406 which stated that the will was executed under the supervision of an attorney. The attorney who supervised the execution of the instrument also submitted an affidavit which indicated that the will was inadvertently stapled in the wrong order.

The court held that an attestation clause is not part of the will itself and is not required as part of the execution of a will or essential to its validity. As a result, the court determined that the signature of the decedent and of the three witnesses were at the end of the will, after all of the dispositive provisions. *In re Estate of Rafaella Viscuso*, N.Y.L.J., p. 20 (Sur. Ct., Kings Co.) (Feinberg, Sur.).

## Reformation of Testamentary Trust

In an uncontested proceeding, a co-trustee sought three different reformations of a testamentary trust as follows: (1) modification of the will so that the trust, instead of terminating when the beneficiary attained the age of 55, continued for the lifetime of the beneficiary; (2) a resolution of conflicting provisions of the will in favor of a determination that the beneficiary's lifetime power to appoint the trust principal was limited, not general; and (3) a severance of the trust into two trusts.

As to the first request for reformation, the Petitioner argued that if the trust beneficiary received any assets from the trust at the stated termination date, it would substantially increase the estate tax in her estate. The court determined that this argument failed to state a cause of action for reformation. The court found that the terms of the trust were clear and unambiguous. When the purpose of a testator is reasonably clear by reading his words in their natural and common sense, the courts have not the right to annul or pervert that purpose upon the ground that a consequence of it might not have been thought of or intended by him. These principles, which are paramount to the law of reformation, are not affected by the presumption that all testators desire whenever possible to preserve all allowable estate tax exemptions and deductions. Accordingly, petitioner's first request for reformation was denied.

With respect to the second request for reformation, the court found that a drafting error was evident from the face of the instrument. If there is a scrivener's error in transcribing a settlor's intention at the time of creating the trust, it is correctable by the court in an action to reform the instrument. Upon

a reading of the will, the court found that it was the testator's intent to limit the beneficiary's lifetime power to appoint the trust property. Accordingly, that branch of the petition was granted.

Finally, the application for the separation of the trust into two separate trusts, one of which would be immune from the generation-skipping transfer tax, was granted, inasmuch as the law expressly authorized the trustee to make such division without court approval. (EPTL 7-1.13) *In re Estate of Catalina K. Meyer*, N.Y.L.J., Feb. 26, 2002, p. 18 (Sur. Ct., N.Y. Co.) (Preminger, Sur.).

## Revocation of Will

In a contested probate proceeding, the sole issue remaining for determination was whether the propounded instrument was revoked by cancellation, obliteration or other mutilation.

The instrument offered for probate had seven dispositive clauses. The original instrument was given to the decedent upon execution, but was not found until two years after his death. When found, the instrument had numerous handwritten additions, interlineations and cross-outs. Affidavits from the attesting witnesses, one of whom was the attorney-draftsman, indicated that none of these changes were apparent on the instrument at the time of execution. In view thereof, the issue before the court was whether the interlineations and deletions to the will constituted an obliteration thereof in conformity with the requirements of EPTL 3-4.1(a)(2)(A).

Generally, if the markings do not affect the will in its entirety, or a vital part thereof, there is no revocation. Hence, where the words "Null and Void" with the dated signature of the decedent were written across the instrument, touching every dispositive provision as well as the original signature, the markings were held to be of such an extent as to constitute a cancellation. *See In re Barnes*, 76 Misc. 382. On the other hand, where the alterations do not affect the entire instrument or parts of the testamentary scheme, it has been held that there is no revocation.

In the propounded instrument, the court noted that the greatest changes were in two clauses of the instrument affecting the disposition of the decedent's personal belongings, and a bequest in trust for the benefit of one of her sisters. The remaining changes constituted minor additions and subtractions from the numerous general bequests that did not affect the overall testamentary scheme. The beneficiaries of the bequests remained the same; the only changes being to the amounts that some of them would receive. The residuary clause was untouched; no clauses were crossed out in whole, and there was no alteration to the decedent's signature or the attestation clause. Nor were there any writings across the instrument indicating that it was void or cancelled. Finally, none of the changes were initialed or signed, nor was proof offered as to who made the changes.

Under these circumstances, the court determined that the changes did not constitute a cancellation or obliteration of the instrument pursuant to EPTL 3-4.1(a)(2)(A). The changes having been made subsequent to execution, the court held that they were ineffectual, and admitted the instrument to probate as originally drawn. *In re Estate of Carmine Porta, a/k/a Thomas Porta*, N.Y.L.J., Feb. 21, 2002, p. 23 (Sur. Ct., Kings Co.) (Feinberg, Sur.).

## Revocation of Will

In a contested probate proceeding, the question before the court was whether the alterations made by the decedent in preparation for the drafting of a new will amounted to a revocation of the instrument pursuant to EPTL 3-4.1(a)(2)(A).

The propounded instrument was dated May 30, 1995. It made a number of bequests of jewelry and general bequests to family members, and left the residue of the estate to family members. The will was drafted by the decedent's attorney, and after execution, the original was kept by the decedent.

Several years after the execution of this instrument, the decedent went to her attorney in order to have a new will prepared. She presented him with the original of her will, dated May 30, 1995, on which she made handwritten changes reflecting the provisions she wished in her new will. The attorney made notes at this conference, the decedent paid the firm a fee for the meeting, and a date was established for the execution of the new document. On the envelope containing the will of May 30, 1995, the decedent indicated that the instrument had been revised, and signed and dated her name. Unfortunately, the decedent died prior to the new will being executed.

The nominated executrix under the will dated May 30, 1995, sought its probate, without the alterations. Objections were filed by the decedent's sister on the grounds that it had been revoked. The proponent moved for summary judgment dismissing the objections, which application was granted.

The court found that the changes made by the decedent to the will of May 30, 1995, were not with the intention to revoke the instrument, but rather to indicate to her attorney what the provisions of her new will were to be. *See In re Kerns*, 7 Misc. 2d 806.

Further, the court found that even if there was such an intention, the markings to the instrument did not constitute a revocation in compliance with the provisions of EPTL 3-4.1(a)(2)(A). To act as a revocation, the obliteration must be to the entire will; there is no provision for partial revocation or alteration. In the case presented, the obliteration was not of the entire testamentary scheme, but rather was an alteration of only certain dispositions. This being the case, the decedent's acts could not be considered a revocation of the entire instrument, and the objections to probate were dismissed. *In re Estate of Rose Carcaci*, N.Y.L.J., Mar. 12, 2002, p. 23 (Sur. Ct., Kings Co.) (Feinberg, Sur.).

### Surcharge of Fiduciary

In a proceeding wherein the Public Administrator was directed to complete the accounting of the former executor and wind up the estate, the guardian *ad litem* for an infant beneficiary of the estate requested that the executor be directed to pay his fees as well as the unpaid attorney's fees and commissions.

The court found that as a result of the objections raised by the guardian *ad litem*, the executor had been surcharged in excess of $23,000. The court further found that pursuant to SCPA 405, the fees of a guardian *ad litem* may be made payable from, *inter alia*, "any other party" upon good cause shown. The court noted that "good cause" has been found in cases where the actions of a party have generated "unnecessary, unfounded, or purely self-serving litigation that resulted in the appointment of a guardian." *See In re Ault*, 164 Misc. 2d 272. Although that criteria did not strictly apply to the circumstances presented, the court recognized that an errant fiduciary may be charged for the legal expenses incurred in establishing his wrongdoing and obtaining recoupments. *See, e.g., Parker v. Rogerson*, 49 A.D.2d 689. Accordingly, the court held that "good cause" to charge any party with compensation awarded a guardian *ad litem* includes charging a party who is a fiduciary with the legal services rendered by a guardian *ad litem* in establishing the fiduciary's wrongdoing. The court therefore directed that a portion of the fees of the guardian *ad litem* be charged against the former executor of the estate. The court further directed that one-half of the unpaid fees of the Public Administrator, as well as one-half the fees of counsel for the former executor, be charged against him personally. *In re Estate of Olga Giuliano*, N.Y.L.J., Jan. 10, 2002, p. 30 (Sur. Ct., Nassau Co.) (Riordan, Sur.).

### Surcharge of Fiduciary

In an accounting by the fiduciary of a deceased fiduciary, the objectant moved for summary judgment with respect to several of her objections, and the petitioner cross-moved for summary judgment dismissing the objections.

The court noted that all the actions or inactions for which relief was sought by the objectant occurred during the tenure of the deceased fiduciary. As the legal representative of the deceased fiduciary, the petitioner's only function, in the absence of a court order to the contrary, was to render an account of the deceased fiduciary. In so doing, he assumed liability only for those assets of the underlying estate which have come into his hands; he did not become liable for all of the acts of the deceased fiduciary.

Accordingly, the objectant's motion for summary judgment was denied; the cross-motion of the petitioner was granted to the extent that he was absolved from personal liability with respect to actions committed by the deceased fiduciary. *In re Estate of Henry Knese*, N.Y.L.J., Dec. 31, 2001, p. 24 (Sur. Ct., Nassau Co.) (Riordan, Sur. ).

### Termination of Trust Denied

In a proceeding requesting, *inter alia*, termination of a trust, the court denied the relief on the grounds that the intention of the creator would be frustrated.

The petitioner claimed that the operation and management of the underlying trust assets could best be managed by accelerating the remainder interests held by her son. The trust consisted of minority interests in two closely held corporations owning real property. The balance of the stock was owned by the decedent's son. The properties, according to the petitioner, needed refinancing, which would be easier for the son to accomplish if he did not require the trustee's approval.

The court held that the petitioner's request failed to comply with the requirements of EPTL 7-1.9, and ran counter to the intentions of the testator. The trust terms provided that it could be invaded for the health, education and support of the petitioner. Based upon this language, the court concluded that the decedent clearly did not intend that invasion of principal be utilized as a means of distributing the trust assets regardless of need. Accordingly, the relief requested by the petitioner was denied. *In re Estate of Alfonso M. Simon, Jr.*, N.Y.L.J., Feb. 28, 2002, p. 20 (Sur. Ct., N.Y. Co.) (Preminger, Sur.).

### Transfer of Proceeding

On an application by the executor of the decedent's estate for an order consenting to the transfer of a Supreme Court action to the Surrogate's Court, the Surrogate's Court denied the relief, holding that the action for sexual harassment was one which was not within the specialized knowledge or expertise of the Surrogate's Court, that it did not involve the executor's administration of the decedent's estate, and that trial would be reached in the Supreme Court in the same or similar time as Surrogate's Court. *In re Estate of Richard A. Leopold*, N.Y.L.J., Jan. 25, 2002, p. 22 (Sur. Ct., Nassau Co.) (Riordan, Sur.).

### Undue Influence

In a proceeding for the appointment of a guardian for an alleged incapacitated person (AIP), the court, *inter alia, sua sponte* declared a will executed by the AIP to be invalid on the grounds of undue influence committed by her home health care attendants, in concert with their attorney. Although the court acknowledged that such matters were usually reserved for the Surrogate, it equally acknowledged its general jurisdiction to make the determination in light of the uncontroverted facts before it at the time.

Specifically, the court found that the decedent lacked testamentary capacity at the time the will was executed. She was neither lucid nor rational, nor likely to have read the instrument prior to its signing.

Further, the court determined that the instrument was the product of the "extraordinary undue influence" exerted upon the decedent by her home health attendants, who were the sole beneficiaries thereunder. In this regard, the court pointed to the unnatural provisions of the instrument, particularly given the existence of the decedent's father, half-brother and long-time friend, who was the beneficiary under the decedent's prior will. Additionally, the court found that the confidential relationship between the decedent and the home health attendants, and their involvement in procuring the execution of the document, created a presumption of undue influence, which they failed to rebut.

> To the contrary, the Court [found] the Will was the product of the influence of the two [home health attendants] who cruelly utilized their confidential relationship and desperate dependence on them by [the AIP] for her day-to-day survival to create a document which [was] the unnatural and unexplained departure from the [AIP's] previously expressed intention.

*In re Ruby Slater*, N.Y.L.J., Feb. 11, 2002, p. 28, (Sup. Ct., Queens Co.) (Justice Thomas).

### Waiver of Requirements Under SCPA 2307-a

In a miscellaneous proceeding, the attorney-fiduciary requested that the court waive the requirements of SCPA 2307-a. The will of the decedent was dated August 16, 1998.

In support of the application, the attorney-fiduciary stated that his representation of the decedent and her family was extensive, and that as a result, the decedent insisted that he serve as the executor of the estate. He stated that he advised the decedent that he would be entitled to executor's commissions and that his firm would be entitled to legal fees for handling the administration of the estate. This information was never reduced to writing, though the attorney-fiduciary claimed that the decedent understood its import. Although semi-retired, counsel stated that all legal services in his firm are performed by his son, who is the alternate executor named in the will.

In considering the application, the court reviewed the history of SCPA 2307-a, and the frequency of reported decisions which have addressed its scope. Significantly, in this regard, the court noted its concurrence with those opinions which held that the disclosure required by the statute must be contained in a writing separate from the will.

With respect to the issue presented, the court recognized that waiver of the statutory requirements has generally been granted where circumstances, beyond the control of the attorney-fiduciary, make it impossible, despite reasonable good faith effort, to ensure the requisite disclosure. *See, e.g., In re Kaufman*, N.Y.L.J., Mar. 15, 1999 (Sur. Ct., Suffolk Co.). On the other hand, where the requisite disclosure was not obtained by the attorney-fiduciary, despite the opportunity to do so, waiver of the statutory provisions will not be granted. *See In re DeMontagut,* 178 Misc. 2d 521.

The court further pointed to the fact that although the petitioner was semi-retired and would not be receiving fees for legal services rendered to the estate, the statutory requirements of SCPA 2307-a were nevertheless applicable. *See In re McDonnell*, 179 Misc. 2d 286, *aff'd*, 265 A.D.2d 557. This was particularly warranted in circumstances such as those presented where the attorney-fiduciary was affiliated with the firm performing legal services on behalf of the estate.

Based upon the foregoing, the court found that the petitioner failed to demonstrate a good-faith effort to obtain the disclosure statement required by SCPA 2307-a, though he had the opportunity to do so. Accordingly, the court denied the petitioner's application for a waiver of the statute, and limited petitioner's commissions to one-half the statutory amount to which he would otherwise be entitled. *In re Estate of Mary McGarry*, N.Y.L.J., Jan. 1, 2002, p. 31 (Sur. Ct., Suffolk Co.) (Czygier, Sur.).

## Waiver and Consent

In a proceeding to vacate an accounting decree, the petitioner sought to withdraw her waiver and consent in order to file objections to the account of the trustee. The basis of the proposed objections was the co-trustee/bank's alleged imprudent management of the trust's holdings of Eastman Kodak stock in the 1970s as set forth in *In re Janes*.

After a fact-finding hearing, the court determined that the waiver had not been knowingly executed by the petitioner, and granted the relief requested. In doing so, the court recited the applicable law which allows a waiver to be withdrawn post-decree, upon a showing that: (1) the waiver was obtained by fraud, misrepresentation, misunderstanding, undue influence, collusion or some other similar ground; (2) the parties can be placed in a position of *status quo ante*; and (3) the proposed objections raised are meritorious. However, where fraud is alleged in the context of a fiduciary relationship, fraud is presumed, and the burden shifts to the fiduciary to show by clear and convincing evidence the absence of fraud or other misconduct.

Despite the rule that a competent adult is chargeable with knowledge of the contents and effect of a document he or she reads and signs, the court noted several critical facts which indicated that the waiver was not knowingly and intelligently given: to wit, that the petitioner had never reviewed the subject accounting prior to her execution of the waiver, that the effect of the waiver was never explained to the petitioner, and the circumstances which compelled an officer from the bank to travel to California in order to hand-deliver the waiver to the petitioner and wait for it to be signed. *In re Estate of Blanche Hunter*, N.Y.L.J., Mar. 12, 2002, p. 25 (Sur. Ct., Westchester Co.) (Scarpino, Sur.).

**Ilene S. Cooper—Counsel, Farrell Fritz, P.C., Uniondale, New York.**

**Donald S. Klein—Donald S. Klein, P.C., White Plains, New York.**

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Robert W. Sheehan (Chair)
101 Park Avenue
New York, NY 10178

S. Jeanne Hall (Vice-Chair)
One Rockefeller Plaza, Suite 301
New York, NY 10020

**Committee on Continuing Legal Education**
Richard P. Wallace (Chair)
279 River Street
P.O. Box 1530
Troy, NY 12181

Stephen B. Hand (Vice-Chair)
300 Garden City Plaza
Garden City, NY 11530

**Committee on Elderly and Disabled**
Warren H. Heilbronner (Chair)
2400 Chase Square
Rochester, NY 14604

A. Robert Giordano (Vice-Chair)
235 Mamaroneck Avenue, Suite 205
White Plains, NY 10605

Robert Kruger (Vice-Chair)
225 Broadway, Room 4200
New York, NY 10007

Gloria S. Neuwirth (Vice-Chair)
330 Madison Avenue, 35th Floor
New York, NY 10017

**Committee on Estate Litigation**
Gary B. Freidman (Chair)
600 Third Avenue
New York, NY 10016

Karin J. Barkhorn (Vice-Chair)
245 Park Avenue
New York, NY 10167

Gary E. Bashian (Vice-Chair)
235 Main Street, 6th Floor
White Plains, NY 10601

Hon. John M. Czygier, Jr. (Vice-Chair)
320 Center Drive
Riverhead, NY 11901

John R. Morken (Vice-Chair)
West Tower, 14th Floor
EAB Plaza
Uniondale, NY 11556

Marilyn Ordover (Vice-Chair)
19 Grace Court, Apt. 6A
Brooklyn, NY 11201

**Committee on Estate Planning**
Denise P. Cambs (Chair)
5701 West Genesee Street, Suite 100
Camillus, NY 13031

Susan Taxin Baer (Vice-Chair)
399 Knollwood Road, Suite 212
White Plains, NY 10603

Louis W. Pierro (Vice-Chair)
21 Everett Road Extension
Albany, NY 12205

Richard E. Schneyer (Vice-Chair)
405 Lexington Avenue, 8th Floor
New York, NY 10174

Linda J. Wank (Vice-Chair)
488 Madison Avenue, 9th Floor
New York, NY 10022

**Committee on Estate and Trust Administration**
Anne Farber (Chair)
100 Park Avenue, 12th Floor
New York, NY 10017

Janet L. Blakeman (Vice-Chair)
1133 Avenue of the Americas
New York, NY 10036

Ilene S. Cooper (Vice-Chair)
West Tower, 14th Floor
EAB Plaza
Uniondale, NY 11556

Victoria L. D'Angelo (Vice-Chair)
5888 Main Street
Williamsville, NY 14221

Susan Greenwald (Vice-Chair)
16 West 16th Street, Apt. 8AN
New York, NY 10011

**Committee on Governmental Relations**
Thomas E. Dolin (Chair)
16 Eagle Street
Albany, NY 12207

Thomas J. Collura (Vice-Chair)
90 State Street, Suite 1011
Albany, NY 12207

Michael K. Feigenbaum (Vice-Chair)
East Tower, 15th Floor
190 EAB Plaza
Uniondale, NY 11556

**Committee on International Estate Planning**
Gerard F. Joyce, Jr. (Chair)
452 5th Avenue, 17th Floor
New York, NY 10018

Michael W. Galligan (Vice-Chair)
666 Fifth Avenue
New York, NY 10103

Davidson T. Gordon (Vice-Chair)
78 Elmwood Avenue
Rye, NY 10580

Richard E. Schneyer (Vice-Chair)
405 Lexington Avenue, 8th Floor
New York, NY 10174

**Committee on Legislation**
Ronald J. Weiss (Chair)
Four Times Square, 28th Floor
New York, NY 10036

Richard J. Bowler (Vice-Chair)
10 Bank Street, Suite 650
White Plains, NY 10606

Lenore W. Tucker (Vice-Chair)
233 Broadway, Suite 915
New York, NY 10279

**Committee on Life Insurance and Employee Benefits**
David A. Pratt (Chair)
80 New Scotland Avenue
Albany, NY 12208

Robert F. Baldwin, Jr. (Vice-Chair)
100 Clinton Square
126 North Salina Street, Suite 320
Syracuse, NY 13202

Edward Falk (Vice-Chair)
4 Times Square, 23rd Floor
New York, NY 10036

**Committee on Membership and Relations with Local Bar Associations**
George E. Riedel, Jr. (Chair)
42 Delaware Avenue, Suite 300
Buffalo, NY 14202

**Committee on Newsletter and Publications**
Magdalen Gaynor (Chair)
10 Bank Street, Suite 650
White Plains, NY 10606

Michael Stephen Markhoff (Vice-Chair)
123 Main Street, 9th Floor
White Plains, NY 10601

Glenn M. Troost (Vice-Chair)
114 West 47th Street
New York, NY 10036

**Committee on Practice and Ethics**
M. Anne O'Connell (Chair)
331 Madison Avenue, 3rd Floor
New York, NY 10017

Carl T. Baker (Vice-Chair)
One Broad Street Plaza
P.O. Box 2017
Glens Falls, NY 12801

S. Jeanne Hall (Vice-Chair)
One Rockefeller Plaza, Suite 301
New York, NY 10020

Jerome L. Levine (Vice-Chair)
345 Park Avenue
New York, NY 10154

Bonnie McGuire Jones (Vice-Chair)
Executive Woods, Suite 180
855 Route 146
Clifton Park, NY 12065

**Committee on Surrogates Court**
Hon. Cathryn M. Doyle (Chair)
16 Eagle Street
Albany, NY 12207

Maureen A. Conley (Vice-Chair)
16 Eagle Street
Albany, NY 12207

Donald S. Klein (Vice-Chair)
10 Bank Street, Suite 650
White Plains, NY 10606

Stacy L. Pettit (Vice-Chair)
16 Eagle Street
Albany, NY 12207

**Committee on Taxation**
Philip L. Burke (Chair)
700 Crossroads Building
2 State Street
Rochester, NY 14614

Edward Falk (Vice-Chair)
4 Times Square, 23rd Floor
New York, NY 10036

Georgiana James Slade (Vice-Chair)
1 Chase Manhattan Plaza
New York, NY 10005

**Committee on Technology**
David Goldfarb (Chair)
350 5th Avenue, Suite 1100
New York, NY 10118

**Ad Hoc Committee on Multi-State Practice**
Ira M. Bloom (Chair)
80 New Scotland Avenue
Albany, NY 12208

Pamela R. Champine (Vice-Chair)
47 Worth Street
New York, NY 10013

Philip G. Hull (Vice-Chair)
One Battery Park Plaza
New York, NY 10004

Ronald S. Kochman (Vice-Chair)
222 Lakeview Avenue, Suite 950
West Palm Beach, FL 33401

# Executive Committee District Representatives


**First District**

Colleen F. Carew
350 Broadway, Suite 515
New York, NY 10013
(212) 896-3310

**Second District**

Gary R. Mund
212 East Broadway
New York, NY 10002
(718) 643-5201

**Third District**

Stacy L. Pettit
16 Eagle Street
Albany, NY 12207
(518) 487-5391

**Fourth District**

Michael R. Suprunowicz
1430 Balltown Road
Niskayuna, NY 12309
(518) 374-3399

**Fifth District**

Elizabeth A. Hartnett
4 Clinton Square, Suite 106
Syracuse, NY 13202
(315) 476-0532

**Sixth District**

John G. Grall
P.O. Box F 1706
Binghamton, NY 13902
(607) 763-9200

**Seventh District**

Nicole M. Marro
P.O. Box 31051
Rochester, NY 14603
(585) 263-1396

**Eighth District**

Robert I. Jadd
1720 Liberty Building
420 Main Street
Buffalo, NY 14202
(716) 854-3807

**Ninth District**

Richard J. Bowler
10 Bank Street, Suite 650
White Plains, NY 10606
(914) 993-0936

**Tenth District**

Ilene S. Cooper
West Tower, 14th Floor
EAB Plaza
Uniondale, NY 11556
(516) 227-0736

**Eleventh District**

Mindy J. Trepel
95-25 Queens Boulevard, 6th Floor
Flushing, NY 11374
(718) 459-9000

**Twelfth District**

Kate E. Scooler
851 Grand Concourse
Bronx, NY 10451
(718) 590-3623

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# TRUSTS AND ESTATES LAW SECTION NEWSLETTER


**Editor**
Magdalen Gaynor
10 Bank Street, Suite 650
White Plains, NY 10606

**Recent Decisions Editor**
John C. Welsh
Albany Law School
80 New Scotland Avenue
Albany, NY 12208

**Section Officers**

**Chair**
Arlene Harris
425 Park Avenue
New York, NY 10022

**Chair Elect**
Timothy B. Thornton
75 State Street
Albany, NY 12207

**Secretary**
G. Warren Whitaker
126 East 56th Street, 17th Floor
New York, NY 10022

**Treasurer**
Michael E. O'Connor
One Lincoln Center, Suite 275
Syracuse, NY 13202


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ISSN 1530-3896

Trusts and Estates Law Section
New York State Bar Association
One Elk Street
Albany, New York 12207-1002

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