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A Message from the Section Chair

Our Fall Meeting, held at the Silverado Resort in Napa, California, was a resounding success. Over 150 members, guests, and speakers enjoyed a very interesting and informative program, along with splendid weather, good food (and wine), golf, tennis and the opportunity to be with friends and colleagues. In retrospect, I am convinced that the decision not to cancel was correct. Thanks to all who helped contribute, and a special thank you to Ira Bloom, our Program Chair.

As part of the Friday morning program, Jules Haskel, Wally Leinheardt and Judge Ray Radigan led a discussion of the estate administration complexities arising from the September 11 attack and the resulting tragic loss of thousands of lives. You should all know that our Section and many of our members have been very involved in several volunteer initiatives and ongoing efforts to assist families of victims. I have received several calls from newspapers and magazines around the country seeking information about these efforts—a friend was astonished to see me quoted in *The Philadelphia Enquirer*. I am very proud to be a member of our Section and hope that you all share this feeling. Inasmuch as this tragedy affected so many of our practices, a special information mailing was sent to Section members in the fall.

On the subject of "Be Careful of What You Ask For—You May Get It," I have encouraged members to share with me their thoughts, and especially their concerns, about our operations. One member has questioned the cost of our Fall Meetings, which seem to have become more elaborate over the years. We are indeed mindful of the cost factor and do offer a variety of programs throughout the year. The fall meeting is our only full weekend program, and we have tried (and I think succeeded) to choose locations that will be attractive in and of themselves. We also offer an upstate program each spring—one that is within driving distance of many of our members and which is available at a relatively modest cost.

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NYSBA 125 Years

The morning program in New York City each January is also a little more than a trip to the office for our downstate area members. We hope that the entire package includes something of interest to each member.

"My year as Chair has literally flown by and has been most enjoyable. I could not ask for a better group of people with whom to work."

The morning program in January continued our focus on current topics, featuring discussions on the estate tax "repeal" legislation, the long-awaited and finally enacted revisions to the Principal and Income Act and the very new rules permitting multidisciplinary practices. At the Annual Meeting, Arlene Harris officially succeeds me as Section Chair, and I will fulfill my lifelong ambition of joining the ranks of former chairs. As Vice-Chair, Arlene has been a tremendous resource for me this past year. With her enviable background of experience with the New York County Surrogate's Court, her leadership role at OCA and her experience in private practice, Arlene will be a terrific Chairperson for our Section. I congratulate her and look forward to a year of observing her quietly from the sidelines.

My year as Chair has literally flown by and has been most enjoyable. I could not ask for a better group of people with whom to work. Thanks to all—especially my fellow officers, members of the Executive Committee, Committee Chairs and Vice Chairs, program speakers and social chairs and members—for an unforgettable professional experience.

Stephen M. Newman

Editor's Message

Much has been written on the topic of the changes to the minimum distribution rules of retirement plans and IRAs. A great amount of a client's wealth is often invested in these accounts. As a result, the beneficiary designation form is very important. This Section's Committee on Life Insurance and Employee Benefits has spent much time on this matter and prepared a report which is included in this issue. It is an excellent resource. In past columns, I have described the Section's Committees and the work they have produced, which has made our Section so well respected. This report proves my point and I thank David Pratt and his Committee for sharing this important information with us.

An updated primer on ownership of co-op apartments by trusts is included in this issue. Anita Rosenbloom and Richard Siegler have prepared a detailed article regarding the suitability of QPRTs and revocable trusts as owners of co-op apartments. This thoughtful article includes forms as well, and I know it will be useful to many.

The Principal and Income Act becomes effective on January 1, 2002, and David Arcella has spent time itemizing important points.

The Section's Fall Meeting was enjoyed by all and photos are included. Ira Harris again acted as the inquiring photographer.

There is much more in this issue, as you will see for yourself. Once again, I am safe in saying there is something for everyone.

With this issue, another year of the *Newsletter* has begun. I thank all of the people who provided articles. I also want to thank the Vice Chairs of the Newsletter and Publications Committee. Michael Markhoff and Glenn Troost are invaluable in getting these issues out on a timely basis.

Magdalen Gaynor

Upcoming Meetings of Interest

April 25-26, 2002	New York State Bar Association Trusts and Estates Law Section. Spring Meeting. Binghamton, NY.
October 3-6, 2002	New York State Bar Association Trusts and Estates Law Section. Fall Meeting. Boston, MA.
September 11-14, 2003	New York State Bar Association Trusts and Estates Law Section. Fall Meeting. Victoria, British Columbia.

Housing Cooperatives: Ownership by Trusts

A Retrospective and a Forecast

By Anita Rosenbloom and Richard Siegler

Seven years ago, we co-authored an article discussing trust ownership of cooperative and condominium apartments.[1] We noted then an increase in the number of requests that co-op housing corporations were receiving for permission to transfer co-op apartments to trusts. The increase was attributable in large part to the issuance in 1992 of final Treasury Regulations blessing qualified personal residence trusts (QPRTs). The trend has continued and we believe that it is likely to continue, despite passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This article is intended to update the 1994 article to take account of new developments and our experiences since then in dealing with trust transfers of co-op apartments. Condominium transfers to trusts are beyond the scope of this article and should be dealt with separately.

"Although taken as a whole, the pending changes under EGTRRA are very substantial, the increase in the estate and generation-skipping tax exemptions and drop in the marginal estate, gift and generation-skipping tax rates are phased in very gradually."

There remain two types of trusts into which most transfers are proposed: the QPRT and the grantor trust (also commonly referred to as a "revocable trust" or a "living trust"). In the case of the grantor trust, EGTRRA should have absolutely no impact on the popularity of these trusts, because these trusts are not designed to achieve any estate or gift tax savings. Typically, they are includible in the grantor's gross estate for estate tax purposes.[2] In contrast, as discussed below, the QPRT is a creature of the Internal Revenue Code and generally the sole reason for establishing it is to attain gift and estate tax savings. Whether it makes sense for an individual client to transfer his co-op apartment to a QPRT in light of EGTRRA will depend upon an analysis of traditional factors such as the person's age, state of health, available gift tax exemption, anticipated estate tax exemption, projected taxable estate, cost basis in the apartment, the value of the apartment and a consideration of the client's comfort level in parting with ownership. It also may depend upon his estate planning counsel's ability to predict the future—whether or not there ultimately will be a permanent repeal of the federal estate tax and a substitution of a modified carryover basis regime with respect to assets inherited from a decedent.

Assessing the Impact of the Economic Growth and Tax Relief Reconciliation Act of 2001

Although taken as a whole, the pending changes under EGTRRA are very substantial, the increase in the estate and generation-skipping tax exemptions and drop in the marginal estate, gift and generation-skipping tax rates are phased in very gradually. No changes occur until January 1, 2002, when the estate and gift tax exemptions increase to $1,000,000, and the top estate, gift and generation-skipping tax rates are reduced from 55 percent to 50 percent. Thereafter, the marginal estate, gift and generation-skipping tax rates decline only an additional 5 percent during the period from 2002 to 2009 before repeal of the estate and generation-skipping taxes in 2010. The gift tax continues to apply in 2010 and thereafter at a 35 percent rate. Furthermore, the estate tax exemption does not increase to $1,500,000 until 2004, $2,000,000 until 2006 and jump to $3,500,000 until 2009, before repeal of the tax in 2010. Repeal is not everlasting. Repeal under EGTRRA would apply only for decedents dying during 2010. After that, the "sunset" provisions of the 2001 Act resurrect the estate, gift and generation-skipping taxes as they existed before the 2001 Act was enacted. Commencing on January 1, 2002, the gift tax exemption increases to $1,000,000 but remains frozen at that level indefinitely.

The slow phase-in of the increase in the estate and generation-skipping tax exemptions, uncertainty regarding the ultimate repeal of the estate and generation-skipping taxes and continuation of the gift tax with the exemption fixed at $1,000,000 make it likely that older and very high net-worth individuals will continue to find the QPRT an attractive vehicle for leveraging the use of their $1,000,000 gift tax exemption through its discount features. Individuals with more modest estates may rethink the merits of putting their apartment into a QPRT. A single person who has a life expectancy beyond 2009 and projects a

taxable estate below $3,500,000 may have little incentive to transfer his co-op to a QPRT. A married couple can leave $7,000,000 to their heirs, free of estate tax under EGTRRA through proper coordination of their wills and split ownership of their assets, assuming that they both survive to 2009. If the couple's combined assets are below the $7,000,000 threshold, they may pass on the QPRT. Yet another couple with comparable assets may be inclined to transfer their co-op to a QPRT out of concern that their assets could appreciate beyond $7,000,000, or that either might die prematurely or a feeling of uncertainty about the full phase-in of the estate tax exemption.

"There is much speculation as to whether these onerous and complex carryover basis rules will ever become effective."

In each case, the potential gift and estate tax savings that may be produced by the QPRT must be weighed against the loss of the step-up in basis that would occur for a testamentary transfer occurring in the next eight years. Of course, where an individual has a relatively high cost basis in the residence, this will not be a factor. But for those individuals with a low cost basis, the loss of the step-up should be carefully considered. Under current law, subject to certain limited exceptions, assets inherited from a decedent generally receive a "stepped-up" basis equal to the fair market value of the assets on the date of the decedent's death (or six month anniversary of death if an alternate valuation date is elected). This step-up in basis wipes out the taxable gain on any appreciation in the value of the residence that occurred prior to the decedent's death. In contrast, when an individual gifts a residence to a QPRT, the remainderman receives a carryover basis equal to the lesser of the donor's basis or the fair market value of the residence on the date of the gift (increased by any gift tax paid on any unrealized appreciation).[3] As a result, the built in gain is passed along to the remainderman.[4]

Under EGTRRA, in tandem with the estate tax repeal in 2010, the step-up in the basis of a decedent's assets will be limited to the first $1,300,000 of assets passing to anyone and an additional $3,000,000 of assets passing to the decedent's surviving spouse. The permitted basis increase would be allocated by the executor on an asset-by-asset basis. The basis of all assets acquired from a decedent exceeding the $1,300,000 and $3,000,000 figures will be equal to the lesser of the decedent's adjusted basis, or the fair market value of the assets at the decedent's death. Although not technically part of the new carryover basis regime, EGTRRA revises section 121 of the Internal Revenue Code to allow the $250,000 exclusion of gain on the sale of a principal residence to be claimed by the decedent's estate or beneficiaries.[5] There is much speculation as to whether these onerous and complex carryover basis rules will ever become effective.

For individuals considering transferring a residence with a low cost basis to a QPRT, these meandering and uncertain rules regarding basis should be considered. Regrettably, this somewhat distasteful exercise forces the person to contemplate their life expectancy, since the rules that will apply will be dependent upon the year of death. An older client who is considering a short-term QPRT and has a life expectancy of eight years or less, must weigh the trade-off between the income tax on the capital gain that will be incurred by the remainderman of the QPRT upon the sale of the residence with the potential gift and estate tax savings. (If the individual refrains from transferring the residence to the QPRT and dies before 2010 owning the residence, the step-up in basis would wipeout the gain.) Of course, the potential capital gain may not be of great concern if it is anticipated that the remainderman of the QPRT will continue to own the residence for a lengthy period of time so that recognition of the gain is delayed, or that the remainderman will convert the residence to his principal residence (with the consent of the co-op) and hold it for the requisite period to qualify for the $250,000 exclusion of gain ($500,000 in the case of a married couple) in his own right. For those individuals who reasonably can expect to live until 2010 and have some level of confidence that the estate tax will be repealed and replaced by a modified carryover basis regime (which basically converts the estate tax to an income tax when the residence is sold), they will need to compare the potential gift and estate tax savings produced by the QPRT with the capital gain which will be realized by the remainderman. The remainderman will not be able to take advantage of the $250,000 exclusion of gain which would be available if the residence is the grantor's personal residence and the grantor dies owning it after 2010. Similarly, there will be no opportunity for the grantor's executor to make the basis allocation (up to $1,300,000 if the residence passes to anyone, with an additional $3,000,000 if it passes to the surviving spouse) that would be available if the grantor dies after 2010 owning the residence, whether or not it is his principal residence.

Despite the complexity and uncertainty created by EGTRRA, it is likely that very high net-worth individuals still will perceive benefits in transferring personal residences to QPRTs. Individuals with more

modest estates may be less inclined to do so. It therefore can be expected that cooperative corporations will continue to receive such requests from their wealthier shareholders. Furthermore, the number of requests for transfers to grantor trusts should be undiminished.

From time to time, cooperative corporations also may receive requests for transfers of apartments to a testamentary trust under the will of a deceased shareholder (typically to fund a credit by-pass trust) or a request for a transfer to (or a purchase by) an existing trust established by a third party other than the intended resident. It is likely that these types of requests also will continue. Indeed, it is possible that there will be an increase in the number of requests to transfer co-op apartments to credit shelter trusts under a deceased shareholder's will, as the federal estate tax exemption expands over the next eight years and a larger portion of the estate will pass into these trusts.

Since it is likely that cooperative corporations will continue to receive requests for transfers to trusts, we will now discuss the ramifications of these transfers from the perspective of the co-op, with a view towards facilitating shareholder requests.[6]

Role of Counsel

For those co-ops which have not already confronted the issue of trust ownership of an apartment, ideally they should seek the advice of counsel in advance to formulate a general policy to deal with such requests so that they are prepared to address them when they are received. When a co-op board receives a request for a transfer to a trust, it should seek the advice of counsel in reviewing the particular request. Counsel for the co-op should understand that the decision whether to permit a transfer to a trust is a policy matter invariably within the discretion of the co-op board. If a board is inclined to accommodate a request for a transfer to a trust, co-op counsel should attempt to ensure that the co-op is at no greater financial or other risk with a trust as a shareholder than with a natural person.

The first step in the process is to review the trust instrument itself.[7] It cannot be emphasized enough that each trust instrument—and this means the entire instrument, not just excerpts—must be reviewed by an attorney well-versed in trust issues. After review of the trust instrument, counsel should advise the board of the basic terms of the trust and any problematic provisions and should recommend documentation which may alleviate board concerns. Counsel should conclude whether there is any legal reason why the transfer to the trust should not be approved. Ultimately, the final decision is within the discretion of the board.

It should be made clear to the shareholder seeking the transfer that the fees of the co-op's counsel for review of the trust documents and advice to the co-op, as well as other fees in connection with the transfer, will be borne by the shareholder seeking the transfer, regardless of whether the transfer is approved. Legal fees can vary dramatically depending on the complexity of the trust instrument and the extent of modifications needed. Shareholders should be made aware of this before the fees are incurred.

QPRTs

The QPRT is a potentially highly effective estate planning device for an individual who owns a valuable residence. Final Treasury Regulations[8] setting out the requirements for this form of trust were issued in 1992. A QPRT is a form of trust which can be used to remove a residence from an individual's gross estate while making a taxable gift valued below that of the present market value of the residence. The residence may be a fee interest in a house, a condominium or a co-op apartment, but it must be a personal residence of the grantor as defined in the applicable Treasury Regulations.

The QPRT plan generally works as follows: An individual transfers a personal residence into an irrevocable QPRT, retaining the right to use the residence for a fixed term, for example five years. The QPRT provides that upon the expiration of the term, the residence is to pass to designated beneficiaries or a follow-on trust for such beneficiaries. The creation of the QPRT is a completed gift to the beneficiaries, but only in the amount of the current actuarial value of the remainder interest, which passes to the designated beneficiaries upon the expiration of the term for which the grantor has reserved the use of the residence. For example, if an individual 60 years of age transfers a residence worth $1,000,000 to a QPRT in October of 2001, retaining the use of the property for 10 years, the amount of the taxable gift would be approximately $484,000.[9] If the term of the QPRT is extended, the taxable gift is reduced. On the other hand, if the term is shortened, the taxable gift would be increased.[10] Note that for the QPRT to achieve estate tax savings, the grantor must survive the fixed term for which he or she retains the right to use the residence. If the grantor dies within the term of the QPRT, the entire QPRT (including the residence) would be includible in his or her taxable estate.

A QPRT will be established under a trust agreement which will be irrevocable (to accomplish its gift and estate tax objectives), although some QPRTs may

grant the trustees a limited power to amend the QPRT to comply with requirements of the tax law. The QPRT is a form of grantor retained income trust, commonly referred to in estate planning circles by the acronym "GRIT." Thus, some of the transmittal papers provided by the shareholder making the request may refer to the trust as a "GRIT." In almost all cases, however, the trust agreement is likely to make a reference to a "QPRT." Although most of the requests that co-ops are likely to receive will involve a QPRT, not all GRITs are QPRTs. In certain limited circumstances, it is possible that the request will be to a GRIT which is not in the QPRT format. It also should be noted that while a QPRT may be a "grantor trust" for *income tax purposes* for a certain period of time, depending upon how the trust instrument is drafted, its provisions will be substantially different from the revocable form of grantor trusts discussed below.

In order to achieve its estate planning objectives, each QPRT must be drafted to comply with the requirements imposed by Treasury Regulations. These require certain language to be incorporated in the trust agreement. Some issues to be considered by a co-op board in reviewing transfer requests are set forth below.

1. The grantor (i.e., the shareholder) will reserve the right to use the apartment for a fixed term of years. Although the QPRT trust agreement may restrict occupancy to the grantor during the term for which he or she has reserved the use of the apartment, co-op boards nevertheless should seek an occupancy agreement executed by the grantor individually and the trustees of the trust, confirming that the grantor and the grantor's family will be the sole occupants of the apartment throughout the term of the trust. Exhibit A is a sample form of occupancy agreement.
2. The trust agreement must preclude the trustees from holding assets other than the subject co-op apartment and cash to meet six months' expenses for the residence. While the trust agreement may permit the infusion of cash from time to time to cover six months of expenses, generally there will be no requirement that such moneys be added to the trust. Although not mandatory under the Treasury Regulations, many QPRTs may impose upon the grantor the obligation to meet all expenses relating to the apartment, such as maintenance and assessment charges due pursuant to the proprietary lease and insurance costs. The fact that the residence is subject to a mortgage does not jeopardize the trust's status as a QPRT under the Treasury Regulations, but may impact the size of the initial taxable gift and have further gift tax implications when mortgage payments are made, depending upon whether the debt is recourse or nonrecourse.[11] Hence, in the case of all QPRTs, it is incumbent on a co-op board to seek a personal guaranty of the proprietary lease obligations by the grantor, as there will be nominal funding of the trust other than with the residence itself. Exhibit B is a suggested form of guaranty.
3. Upon the expiration of the fixed term for which the grantor has reserved the use of the apartment, the trust principal (including the apartment) will pass to designated beneficiaries such as children, other family members or even non-family members. In some cases, the trust agreement will provide that the apartment passes outright to the children or other beneficiaries; in other cases it will provide that it passes into a trust for the particular beneficiaries. For example, it may pass into a combined discretionary trust for the grantor's issue and name a non-family trustee (who is not one of the grantor's issue) as the trustee. Some grantors feel that this gives them more assurance that their children (or other beneficiaries) will not sell the apartment while they remain in residence and that the trustee will enter into a lease which will permit the grantor to continue to occupy the apartment after the expiration of the fixed term. If the grantor wishes to continue to occupy the apartment following the expiration of the fixed term, he or she will have to lease the apartment from the new owners at a fair market rent to avoid potentially adverse gift and estate tax consequences. If a co-op board is willing to consent to the transfer of an apartment into a QPRT, it also must decide whether it is willing at the time of the initial application to also consent to the subsequent transfer of the apartment to the grantor's children (or other beneficiaries) at the expiration of the fixed term.

   If a board is reluctant to pre-approve the transfer to the children (or other beneficiaries) as owners, it could limit its approval to the initial transfer of the apartment into the QPRT. However, this may not fully accommodate the grantor's wishes. It is likely that the grantor will wish to continue to occupy the apartment at the expiration of the fixed term by entering into a lease or similar arrange-

ment with his or her children (or other beneficiaries) who will then become the new owners. For these reasons, the grantor may desire that the co-op board pre-approve the transfer to his or her children (or other beneficiaries) at the expiration of the fixed term. Although this is rarely done, it is entirely a policy decision to be made by the board. A compromise is to allow occupancy by the grantor. It may be possible to permit other occupancies without a change in ownership, such as permitting occupancy by the immediate family of the grantor, who by virtue of the proprietary lease provisions would also be entitled to occupy an apartment.

Note that a board's refusal to pre-approve the transfer to the grantor's children (or other beneficiaries) may only delay the issue since, if the grantor survives the term of the QPRT and the apartment is not sold during the term, the board will most likely receive a request at the expiration of the term for approval of the transfer of the apartment to the beneficiaries. In addition, the board can expect a request for permission of the grantor to sublease the apartment from the new owner, which raises additional policy considerations.

If a co-op board is unwilling to pre-approve the transfer to the grantor's children (or other beneficiaries), it is important that the board obtain a written confirmation from the grantor and the trustees that the board is only approving the initial transfer of the apartment into the trust and that all further transfers by the trustees, including those to the beneficiaries upon the expiration of the fixed term or the grantor's prior death, must be approved by the board at such time. It is also recommended that this letter agreement contain a general confirmation from the grantor and the trustees that, in the event of a conflict between the terms of the trust agreement and the proprietary lease, the co-op's by-laws or certificate of incorporation or the occupancy agreement, the provisions of the proprietary lease, by-laws, certificate of incorporation and occupancy agreement shall prevail. A sample letter agreement can be found in Exhibit C.

4. As noted above, if the grantor does not survive the fixed term, the trust fails as an estate planning device and the trust agreement typically will provide that all of the trust assets (including the apartment) are to be distributed upon the grantor's death as the grantor may appoint pursuant to a testamentary power of appointment, to the executors of the grantor's estate or perhaps to designated beneficiaries. This should not present a problem to the co-op since it is no different than if the grantor owned the apartment individually at the time of death and disposed of it under the terms of a will. All such transfers following the death of the shareholder would require board approval pursuant to the proprietary lease.

5. There will be extensive provisions in the trust agreement which deal with the possibility that the trust could cease to be a QPRT, within the meaning of the Treasury Regulations. In general terms, this could happen if the apartment ceases to be used or held for use by the grantor as a personal residence, if the apartment is sold and a new residence is not purchased within a two-year period or the apartment is destroyed and the proceeds of insurance are received and not used to purchase or construct a new apartment within two years after the date of receipt of such proceeds. In such events, the trust agreement must provide that, within 30 days after the date on which the trust has ceased to be a QPRT, either (a) the trust be terminated and the assets (i.e., the apartment) be distributed to the grantor, (b) the trust be converted to a qualified annuity trust pursuant to which the grantor is entitled to receive a qualified annuity interest (as defined by the applicable Treasury Regulations) or (c) the trustees be given the option of complying with either (a) or (b). These provisions will appear in all QPRTs, as they are required by Treasury Regulations. However, these provisions ought not to be of any concern to a co-op board because the events which trigger them, such as the sale of the apartment or the rental of the apartment so that it ceases to be a personal residence of the grantor, would require board approval in the regular course.

6. It is advisable to obtain an opinion from the grantor's counsel, admitted to practice in the state the laws of which govern the trust, addressed to the co-op, to the effect that: (a) the copy of the trust agreement furnished to the co-op is a true and correct copy; (b) there have been no amendments to the trust agreement; (c) the trust is a valid and existing trust under the law of the particular state cited in the trust agreement; (d) the trustees named in the trust agreement are the current trustees of

the trust; (e) these individuals, in their capacities as trustees, have full authority to execute the proprietary lease and assume all of the obligations thereunder, and to execute the occupancy agreement and letter agreement described above; and (f) the obligations under the proprietary lease which are being assumed by the trustees will be binding upon any successor trustees.

Grantor Trusts

A grantor trust is a revocable, amendable trust created primarily for the benefit of the shareholder/grantor during his or her lifetime. Often, assets other than a co-op apartment will be transferred to a grantor trust. Typically, the income and principal of the trust may be freely used by the trustee for the grantor's benefit during the grantor's lifetime. The grantor trust is often used as a will substitute, providing for the disposition of the trust assets upon the death of the grantor, but does not result in estate or gift tax benefits. There is a perception that the grantor trust permits the avoidance of probate proceedings, saves expenses and facilitates property transfers. However, these benefits may not actually materialize.[12] At the least, the grantor trust may be used to administer assets where the grantor becomes disabled or incapacitated.

The concerns raised by the grantor trust and the QPRT are somewhat different. For example, in the case of a QPRT, the grantor may likely be alive at the termination of the trust, giving rise to issues of occupancy and control of the co-op apartment. Further, virtually the only asset in a QPRT will be the co-op apartment, while a grantor trust is usually funded with other assets. Despite these differences, the documentation recommended to alleviate the concerns raised by both the QPRT and the grantor trust are similar. In a transfer to a grantor trust, as with any transfer of a co-op apartment to a non-individual, the occupancy of the apartment should be controlled by an occupancy agreement similar to that found in Exhibit A. A personal guaranty by the grantor, similar to that in Exhibit B, is advisable as a secondary source of funds for maintenance and other charges should the trustees fail to pay the same. It should be confirmed, by the execution of a letter agreement similar to Exhibit C by the grantor of the trust, the trustees thereof, and any known beneficiaries, that no further transfer of the apartment from the trust, either during the grantor's lifetime or after his or her death will be permitted without board approval, even if the transfer is to a named beneficiary of the trust. Finally, the attorney opinion referred to above should also be obtained.

Testamentary Trusts and Trusts Created by Third Parties

In addition to what have become routine requests for transfers to QPRTs and grantor trusts, from time to time a co-op may receive a request for a transfer to a trust created under the will of a deceased shareholder, usually to fund a credit by-pass trust, or a request for a transfer to, or a purchase by, an existing trust established by a party other than the intended resident. Generally, if the co-op policy permits non-individual shareholders such as trusts to own an apartment, a transferee in these situations should be reviewed like any other transferee, including a review for financial stability. The trust instrument should be reviewed for troublesome issues, such as spendthrift provisions, discussed below. Documentation similar to that recommend for QPRTs and grantor trusts should be obtained.

Spendthrift Provisions

While each trust instrument must be examined for problematic provisions, one particular trust provision co-op boards should be aware of is a "spendthrift" provision which purports to protect the assets of the trust from the creditors of the beneficiary and/or grantor. If a spendthrift provision is valid in the jurisdiction governing the trust, it might preclude a co-op from seeking satisfaction of any claims that it may have against the grantor of the trust (or any other beneficiary of the trust) out of the trust assets, such as claims arising out of a personal guaranty of the proprietary lease obligations. Spendthrift provisions are most common and most troublesome in the case of grantor trusts, because it is likely that the grantor will have transferred substantially all, or at least a significant portion, of his or her assets into the trust. However, in many jurisdictions, including New York, a spendthrift provision in a grantor trust would not be binding against the grantor's creditors.[13]

Regardless of whether as a matter of law a spendthrift provision is binding against the grantor's creditors, a co-op board ought to be wary of permitting the transfer of an apartment to a trust which recites on its face that the shares and proprietary lease (as well as all other assets of the shareholder placed in the trust) would be beyond its reach should it seek to execute a judgment against the grantor or other beneficiaries, as the co-op would be on notice of the existence of these provisions. To alleviate the concerns raised by the presence of a spendthrift provision, it is recommended that either (1) the trust agreement be amended in such a manner as to confirm that the spendthrift provisions shall be of no

force or effect against the co-op, and that any claim that it may have against the grantor, individually, or in his or her capacity as trustee, or against any other trustee, including but not limited to claims arising out of a default under the proprietary lease, may be asserted against and satisfied out of the trust assets; or (2) the attorney's opinion letter referred to above includes a confirmation of the same. An amendment to the trust agreement would appear to be preferable as it would afford the co-op the greatest protection and should be obtainable in the case of an amendable grantor trust. Exhibit D is a suggested form of amendment. While amending a QPRT may be problematic, the spendthrift issue arises less frequently in QPRTs. This is so because the transfer of a co-op apartment will be the sole reason for the QPRT, and co-op approval will invariably be sought before the QPRT is created. Thus, any spendthrift provision can be deleted or revised in the drafting stage.

"In the end, the decision to permit a trust (or other non-natural individual) to own co-op shares and proprietary leases is a policy decision for co-op boards."

Conclusion

There appears to be no legal reason for a co-op board to reject proposed transfers to QPRTs, grantor trusts, testamentary trusts or third-party trusts, provided that the particular trust instrument does not contain problematic provisions, appropriate collateral documentation is obtained and the particular circumstances surrounding the proposed transfer do not otherwise raise independent concerns. Indeed, we would hope that most of these requests would be approved where the co-op can be adequately protected, as most shareholder requests are motivated by a desire to facilitate estate planning.

Unfortunately, we have seen instances where co-op boards have adhered to somewhat rigid policies—not without cost to the shareholder and his intended beneficiaries. For example, what could be a more compelling set of circumstances than to permit the transfer of an apartment to a credit by-pass trust under a will for the benefit of a surviving spouse, when there are otherwise inadequate assets to fund the trust. To deny the request would result in a waste of the decedent's estate tax exemption and higher estate taxes when the spouse dies and the apartment is taxed as part of the second estate.

Another appealing case is where a request is made for the purchase of an apartment by a trust for the primary benefit of the intended resident which was created by a third party, such as a parent or grandparent. The trust (which is the proposed purchaser) may enjoy a tax-favored status, such as being exempt from the generation-skipping tax and insulated from estate tax on the death of the beneficiary. Permitting the purchase by the trust may not only facilitate the purchase, but insulate any appreciation on the residence from estate and generation-skipping taxes.

Regrettably, we know of situations where such requests have been denied at a considerable cost to the deceased shareholder's heirs and the beneficiaries of the third-party trust. Sometimes the refusal of the request may be due to a lack of familiarity by the co-op board or its managing agent with the various forms of trusts and how readily the co-op can be insulated from any financial or other risk resulting from trust ownership. As the use of trusts become more commonplace in estate plans, both for tax and non-tax reasons, and co-op apartments increasingly represent a significant asset of shareholders' estates, we would urge co-op boards to consider these requests with an open mind. Although few in number, there are some buildings which have an absolute policy against permitting trust ownership of apartments.[14] We suggest that such boards review their general policy for the benefit of their shareholders.

In the end, the decision to permit a trust (or other non-natural individual) to own co-op shares and proprietary leases is a policy decision for co-op boards. Some co-op boards have determined that non-individual ownership of co-op apartments is inconsistent with the basic co-op housing principle of owner-occupancy.[15] Most proprietary leases are drafted presuming a natural person as the lessee. They include provisions which do not make sense in cases of non-individual ownership. For example, most proprietary leases restrict occupancy to the named lessee and his or her family; obviously, a trust lessee can have no family. Further, it can be argued that the co-op is at a greater risk of disputes when actual ownership and beneficial ownership are divided as between a trust, its trustees, its grantor and its beneficiaries. While the foregoing concerns may be alleviated for some boards by the documentation we have suggested, the question may arise whether this documentation, which essentially modifies certain terms of a proprietary lease relating to occupancy and transfers, is an amendment of the proprietary lease which is invalid without shareholder approval. Since there is virtually no case law offering guidance on this issue, it is not entirely free from doubt. However, a strong rebuttal to this position can be based on a co-op's absolute right to withhold consent to a trust transfer for any reason, which implies the right

to impose any condition to such transfer. In rare cases, it may be appropriate for a co-op which permits transfers to trusts to consider amending certain provisions of its proprietary lease to reflect this form of non-individual ownership.

Co-op boards, with the advice of counsel, should carefully consider all aspects of trust ownership and formulate a policy which is acceptable and appropriate for the particular building, balancing the desire to accommodate shareholders and the duty to serve the co-op as a whole. Over the past decade, in our experience with approximately 100 co-ops which have confronted this issue with our advice, virtually all have permitted trust transfers. Moreover, those that have allowed trust transfers to date have virtually never encountered problems resulting from trust ownership. Once trust transfers are permitted, it will be difficult for a co-op board to deny this privilege to other shareholders in good standing who are willing to abide by the co-op's requirements for such transfers.

Endnotes

1. Richard Siegler & Anita Rosenbloom, *Co-operatives, Condominiums: Ownership by Trusts,* NYSBA Trusts and Estates Law Section Newsletter, Spring 1994, p. 5.
2. I.R.C. §§ 2036, 2038.
3. I.R.C. § 1015(d).
4. Until recently, it was possible through a clever maneuver to shield the remainderman from the gain by having the grantor reacquire the residence from the QPRT just prior to expiration of the grantor's retained term. Under this "bait and switch" technique, the remainderman would receive cash or other assets. Further, if the grantor retained the residence until death, its basis would be stepped-up. The Internal Revenue Service responded by issuing Treasury Regulations, effective for trusts created after May 16, 1996, requiring that, in order to qualify as a QPRT, the trust instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse or an entity controlled by the grantor or the grantor's spouse. Treas. Reg. §§ 25.2702-5(c)(9).
5. The estate or beneficiaries can only claim the exclusion for a post-death sale of the decedent's principal residence if the decedent used the property as such for at least two of the five years before the sale. The period of occupancy by the decedent also can be added to the period of occupancy by an heir to determine if the heir meets the requirements for his or her own $250,000 exclusion.
6. The Tax Reform Act of 1986 amended I.R.C. § 216 to include in the definition of "tenant-stockholder non-natural persons, including trusts, owning co-op shares." Richard Siegler, "Impact of Tax Reform on Co-op Housing," N.Y.L.J., March 4, 1987, p. 1, col. 1.
7. Note that for various reasons, trusts are established under the laws of different states; just because the co-op apartment is located in New York does not mean the trust will be governed by New York law.
8. Treas. Reg. § 25.2702-5(c).
9. If the transfer is made after November 1, 2001, the figures may vary slightly. This is because the interest rate upon which the Internal Revenue Service's valuation tables are based fluctuate from month to month. The interest rate is equal to 120 percent of the average yield on Treasury obligations with maturities between three and nine years. This example further assumes that the grantor has reserved a contingent reversionary interest in the QPRT instrument providing that, if the grantor fails to survive the trust term, the residence will pass to his estate or as he may appoint by a general testamentary power of appointment. The value of the grantor's contingent reversionary interest reduces the value of the gift.
10. The amount of the taxable gift turns on five factors: (1) the interest rate used by the Internal Revenue Service in its valuation tables, (2) the value of the residence on the date of the gift, (3) the grantor's age, (4) the length of the trust term and (5) whether the grantor has reserved a contingent reversionary interest.
11. Treas. Reg. § 25.2702–5(c)(2)(ii). Note that shareholders with loans must generally obtain their lender's consent to a transfer to a trust.
12. *See Should I Create a Revocable Inter Vivos Trust?*, 63 N.Y. St. B.J. 48 (Dec. 1991).
13. EPTL 7-3.1.
14. In the event that the cooperative corporation refuses to consent to the proposed transfer to a QPRT, the IRS has confirmed that it nevertheless may recognize the transfer for transfer tax purposes. Priv. Ltr. Rul. 94-47-036 (Aug. 29, 1994); Priv. Ltr. Rul. 94-33-016 (May 18, 1994); Priv. Ltr. Rul. 92-49-014 (Sept. 4, 1992). In those cases, after the co-op board disapproved the request for transfer to the QPRTs, the donor assigned beneficial title to the co-op shares and the proprietary lease to the QPRT and undertook as nominee to hold legal title for the QPRT. We would not suggest this course of action as it would be a default under the proprietary lease.
15. Many proprietary leases provide that board consent is not required for a transfer of an apartment to the spouse of the shareholder and/or that board consent to a transfer to a financially responsible member of the shareholder's family may not unreasonably be withheld. This raises the issue of whether a transfer to or by a trust for the benefit of a grantor's spouse or other family member should be subject to the same relaxed consent provisions. In addition, most proprietary lease provisions imposing a flip tax are triggered by a sale and payment of consideration, and as originally drafted do not expressly cover a gift transfer to a trust. Therefore, each flip tax provision should be reviewed. If a board wishes to amend the co-op's proprietary lease to impose a fee upon trust transfers, this almost always requires shareholder approval.

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Richard Siegler is a partner in the New York City law firm of Stroock & Stroock & Lavan LLP and a member of the Committee on Condominiums and Cooperatives of the Real Property Section of the New York State Bar Association. He is also Adjunct Professor at New York Law School where he teaches a course on cooperative housing and condominium law.

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Exhibit A

OCCUPANCY AGREEMENT

[name of trustee] and [name of trustee], as Trustees (collectively, the "Trustees") of the [name of settlor/grantor] Trust, dated ____________ between [name of settlor/grantor], as [Grantor][Settlor], and [name of trustee] and [name of trustee], as Trustees (the "Trust"), are the holders of the shares (the "Shares") of (the "Corporation") allocated to Apartment ___ (the "Apartment") located at [address] and the proprietary lease appurtenant thereto (the "Lease"). The Trustees hereby agree with the Corporation that, notwithstanding any provisions of the Lease or any other document, they will not sublet or permit the occupancy of the apartment by any parties other than [name of settlor/grantor] and [her][his] immediate family (i.e., spouse, children and parents) residing with [her][him]. Any violation of this Agreement shall be considered a default by the Trustees, as lessee, under the provisions of the Lease. The occupant of the Apartment and Trustees shall be subject at all times to the Lease (including house rules) and the by-laws of the Corporation (the "By-laws").

The Trustees acknowledge and understand that the By-laws and Lease provide that the Shares are transferable only as an entirety and only to an assignee of the Lease approved in writing in accordance with the provisions of the Lease. The Trustees hereby represent that any transfer of the Shares or subletting of the Apartment made by them shall be done only in accordance with the provisions of the Lease and the By-laws. In the event of a conflict between the terms of the Trust and the terms of this Agreement, the Lease, the By-laws or the certificate of incorporation of the Corporation, as the same may be amended from time to time, the terms of this Agreement, the Lease, the By-laws and the certificate of incorporation of the Corporation, as the same may be amended from time to time, shall prevail.

The Trustees recognize that the Corporation is relying upon the foregoing representation in permitting a transfer of the Shares of the Lease to the Trustees and that the Corporation would not otherwise consent to such transfer.

The Trustees agree that any and all costs and expenses, including without limitation, reasonable attorneys fees and disbursements, incurred by the Corporation in connection with the enforcement of this Occupancy Agreement shall be deemed additional rent under the Lease.

The Trustees consent to the jurisdiction of the New York courts and consent to the service of process on the Trust by certified mail addressed to the Apartment.

This Agreement may be modified only by a written instrument signed by the Trustees and the Corporation.

This Agreement shall be binding on the estates, heirs, executors, administrators, personal representatives, successors and assigns of each of the undersigned.

This Agreement shall be governed by the internal laws of the State of New York, without giving effect to principles of conflicts of law.

IN WITNESS WHEREOF, the undersigned have executed this Agreement as of the ___ day of ________, ____.

[name of co-op corporation]

By:________________________
Name:
Title:

____
[name of trustee],
as Trustee of the Trust

____
[name of trustee],
as Trustee of the Trust

Accepted and Agreed to:

____
[name of settlor/grantor],
individually and as [Grantor]
[Settlor] [and as Trustee]
of the Trust

Exhibit B

GUARANTY OF LEASE

WHEREAS, by a certain Assignment of Proprietary Lease, dated _________, _________, [name of trustee] and [name of trustee], as Trustees under that certain Trust Agreement dated ______________ between [name of grantor/settlor], as [Grantor] [Settlor], and [name of trustee] and [name of trustee], as Trustees (such Trustees hereinafter collectively called "Assignee"), will acquire all of the lessee's right, title and interest in and to a certain lease (the "Lease") dated ____________, between ("Lessor Corporation"), as lessor, and [name of grantor/settlor], or [her][his] predecessor in interest, as lessee, for apartment ___ ("Apartment") in premises located at ___________ ________________, New York, New York; and

WHEREAS, by instrument dated _________________ ("Assumption of Lease") Assignee will assume all of the obligations of [name of grantor/settlor], as lessee under the Lease, and is about to become the lessee of the Apartment by virtue of said instrument or the execution of a new lease.

NOW, THEREFORE, in consideration of the premises and the consent of Lessor Corporation or its directors to the assignment of the Lease to Assignee and to the transfer to Assignee of the shares of Lessor Corporation which accompany the Lease, [name of grantor/settlor] ("Guarantor") hereby guarantees to Lessor Corporation the timely performance of all of Assignee's obligations under the Lease, including, without limitation, the prompt payment by Assignee of all rent (maintenance charges) and any and all other charges or assessments payable under the Lease, as the same may be amended from time to time, accruing from and after the effective date of the Assumption of Lease.

Guarantor agrees to reimburse the Lessor Corporation for all costs and expenses, including without limitation, reasonable attorneys fees and disbursements, incurred by the Lessor Corporation in connection with the enforcement of this Guaranty. In the event Assignee defaults or fails to pay any sum when due, Lessor Corporation may require Guarantor's performance without first requiring that the Assignee perform.

The obligations of Guarantor hereunder are direct and absolute. A separate cause of action or separate causes of action may be brought and prosecuted against any Guarantor without the necessity of joining Assignee or previously proceeding or exhausting any remedy against Assignee or any other person who might have become liable for the indebtedness of the Trust by assumption thereof.

Notice of default or any extension of time to cure a default is hereby waived. This Guaranty shall remain in effect notwithstanding the modification of the Lease or the execution of a new lease by Assignee or any modification thereof.

This Guaranty is an absolute and unconditional guaranty and may not be changed or terminated orally but only by an agreement in writing signed by the party against whom enforcement of such change or termination is sought. All rights and remedies under the Lease and this Guaranty are cumulative.

This Guaranty and all of its provisions shall be binding on Guarantor and Guarantor's estate, heirs, executors, administrators, personal representatives, successors and assigns.

In any action on this Guaranty, guarantor waives trial by jury and the right to assert any counterclaim.

This Guaranty shall be governed by the internal laws of the State of New York, without giving effect to principles of conflicts of law.

New York, N.Y.
Date: __________________

____
[name of grantor/settlor]

State of New York)
: ss.
County of New York)

On the _____ day of ____________________ in the year ____, before me, the undersigned, personally appeared [NAME OF GRANTOR/SETTLOR], personally known to me or proved to me on the basis of satisfactory evidence to be the individual whose name is subscribed to the within instrument and acknowledged to me that (s)he executed the same in his/her signature on the instrument, the individual, or the person upon behalf of which the individual acted, executed the instrument.

____
Notary Public

Exhibit C

LETTER AGREEMENT

[name of trustee] and
[name of trustee]
Trustees of The [name of settlor/grantor] Trust
____
New York, New York _________

Date:_________________

[name of co-op]

Re: Transfer of Apartment

Dear Sir/Madame:

As a condition to your approval of the transfer of the shares of [name of co-op] (the "Shares") and the proprietary lease (the "Lease") allocated to Apartment ____ at, [address] New York, New York (the Shares and the Lease may be collectively referred to herein as the "Apartment"), to us, [name of trustee and [name of trustee], as Trustees of the [name of settlor/grantor] Trust, dated _________, _________, between [name of settlor/grantor], as [Grantor][Settlor], and us, as Trustees (the "Trust"), we, as Trustees of the Trust, [name of known beneficiary, if any, individually,] and [name of settlor/grantor], individually, hereby acknowledge and agree that, notwithstanding any purported disposition in the Trust Agreement, you shall retain and reserve the rights granted to you under the Lease, under your by-laws (the "By-laws") and under your certificate of incorporation (the "Certificate") to review and approve or reject in your sole discretion any further transfer of the Apartment by us, as Trustees, including, without limitation, any transfer which may take effect upon the death of [name of settlor/grantor] or the termination of the Trust, whether to a beneficiary of the Trust, to another trust or otherwise.

We, [name of trustee] and [name of trustee], in our capacities as Trustees of the Trust, and [name of settler/grantor], individually and as [Grantor][Trustee] of the Trust, agree that we shall be jointly and severally liable for any and all costs and expenses, including without limitation, reasonable attorneys fees and disbursements, incurred by you in the enforcement of this Letter Agreement, and that such costs and expenses shall be deemed additional rent under the Lease.

We, [name of beneficiary, if any] and [name of settlor/grantor] hereby further acknowledge and agree that, in the event of a conflict between the terms of the Trust and this letter agreement, the Lease, the By-laws, the Certificate or the Occupancy Agreement of even date herewith, the terms of this letter agreement, the Lease, the By-laws, the Certificate and the Occupancy Agreement shall prevail.

This letter agreement shall be binding on the estates, heirs, executors, administrators, personal representatives, successors and assigns of each of the undersigned.

This letter agreement shall be governed by the internal laws of the State of New York, without giving effect to principles of conflicts of law.

Very truly yours,

____
[name of trustee], as Trustee of the Trust

____
[name of trustee], as Trustee of the Trust

ACKNOWLEDGED AND AGREED TO:

____
[name of settlor/grantor], individually [and as Trustee] of the Trust

____
[name of beneficiary, if any, individually]

Exhibit D

PROPOSED AMENDMENT OF SPENDTHRIFT PROVISIONS

"The Grantor hereby directs that the spendthrift provisions set forth in Paragraph _____ of said Trust Agreement shall be of no force or effect against [NAME OF CORPORATION], and hereby confirms that any claims [NAME OF CORPORATION], may have against the Grantor in her[his] individual capacity or against any other beneficiaries or Trustees of any trust established under this Trust, including but not limited to any claims arising out of the guarantee which the Grantor is making or arising out of a default under the lease, may be asserted against and satisfied out of the assets of any trust established under this Trust Agreement and subject to judgment, levy, execution, sequestration, attachment, bankruptcy proceedings or other legal or equitable process in connection therewith, whether such claims arise during the life of the Grantor or after her[his] death. The Grantor hereby directs that the provisions of this Amendment shall not be modified, amended or revoked without the prior consent of [NAME OF CORPORATION] and any such purported modification, amendment or revocation shall be ineffective against [NAME OF CORPORATION]."

New York State Bar Association Trusts and Estates Law Section

Committee on Life Insurance and Employee Benefits[1]

Report on Customized Beneficiary Designations for Individual Retirement Accounts

September 2001

1. Introduction[2]

It is not uncommon for a client's retirement savings to represent 50 percent or more of the client's total wealth. If the client has retired, it is almost always preferable, wherever possible, to withdraw the client's funds from the employer's qualified plan, and roll them over to an individual retirement account (IRA), as this gives the client much greater control over the funds, particularly with respect to investments and the time and manner in which the funds are distributed.[3]

"The premise of this report is that, for any IRA of any size, the terms of the IRA document, and the terms of the owner's beneficiary designation form . . . governing the distribution of the IRA assets, are as important as the owner's other estate planning documents, and should be prepared with as much care as the owner's will or revocable trust."

A traditional (as opposed to a Roth) IRA is established by executing IRS Form 5305 (Traditional Individual Retirement Trust Account) or 5305-A (Traditional IRA Retirement Custodial Account). Each form consists of twelve pages of text and two pages of instructions. The forms and instructions state that provisions may be added by agreement between the IRA owner and the financial institution (the IRA sponsor) that sponsors the IRA. Most IRA sponsors do add provisions, such as binding arbitration and indemnification provisions, which are typically designed to further their interests and to protect them against liability. Relatively few IRA owners (or their advisors) take the opportunity to add provisions that benefit the owner and his or her beneficiaries, perhaps under the mistaken impression that all IRAs are the same[4] and that the standard form adequately addresses all the important issues. Furthermore, many IRA owners complete their IRA beneficiary designations without considering issues that are left open by the standard form, and without taking care to ensure that the beneficiary designation is consistent with their overall estate planning.

The premise of this report is that, for any IRA of any size, the terms of the IRA document, and the terms of the owner's beneficiary designation form (BDF) governing the distribution of the IRA assets, are as important as the owner's other estate planning documents, and should be prepared with as much care as the owner's will or revocable trust. This will generally require that individualized additional provisions be drafted and agreed with the IRA sponsor.

This report discusses BDFs for traditional IRAs, including rollover IRAs and accounts under a simplified employee pension plan (SEP) or SIMPLE IRA. Although most of the issues discussed are also applicable to qualified plans, 403(b) plans and Roth IRAs, the report does not address the additional considerations that apply to such programs.

2. Threshold Issues

2.1 Choice of IRA Sponsor

Before beginning to draft a BDF, it is essential to read the IRA document, paying particular attention to the additional Articles inserted by the IRA sponsor, in order to determine (1) whether any of the existing provisions conflict with the desired provisions of the BDF and (2) which issues must be covered in the BDF, because they are not satisfactorily covered in the IRA document. Second, it is important for either the client or the attorney to contact the IRA sponsor to confirm that it will accept additions to its standard form. This should not be a major issue, because any changes will affect only this client's IRA. However, some sponsors are very reluctant to accept changes, or will only accept certain changes. In this situation, the IRA sponsor is more likely to be flexible if the IRA will be substantial in amount, or if there is a long-standing relationship between the client (or the client's business) and the sponsor.

It is important that the proposed changes be submitted for approval by, and negotiated with, someone who has authority to commit the IRA sponsor. Once the changes have been agreed, the IRA docu-

ment should be executed by the client and the IRA sponsor, and the BDF should be executed by the client and accepted, in writing, by the IRA sponsor. Unfortunately, this will not necessarily guarantee that the sponsor will implement the BDF when the time comes,[5] but a written acceptance (particularly if it includes an agreement by the sponsor that it will follow the terms of the BDF) would create a contractual right which could be enforced by the IRA beneficiaries.

If the client's chosen IRA sponsor will not cooperate with this approach, then the client must be advised of the options: either to search for another sponsor that will do so, or to accept an unsatisfactory IRA document that could cause problems (including, in a serious case, additional taxes, premature depletion of the IRA or funds being paid to the wrong beneficiaries).

2.2 Trust or Custodial Account?

The IRA can be set up either as a trust (by using Form 5305) or as a custodial account (by using Form 5305-A).[6] One commentator[7] prefers a trust to a custodial account, because:

1. Trust law is well established, custodial law much less so; and
2. If there is a trust, there should be no doubt that the BDF will be binding. At least in some states, there is uncertainty with respect to a custodial account, unless state law clearly provides that designation of IRA beneficiaries in a custodial IRA is not a testamentary disposition governed by the statute of wills.[8]

He suggests repeating the BDF in the IRA owner's will or, where permissible, incorporating the BDF in the will by reference.

Section 6-101 of the Uniform Probate Code, and the corresponding section 101 of the Uniform Nonprobate Transfers on Death Act, provide that IRA BDFs do not have to comply with testamentary formalities.[9] However, neither of these statutes has been adopted by New York.[10]

3. The Minimum Distribution Rules

IRAs are subject to the minimum distribution rules.[11] The proposed regulations, which were originally issued in 1987, have now been replaced by new proposed regulations issued in January 2001.[12] The new proposed regulations are generally much less complex than the 1987 regulations, but some uncertainties remain. Current IRA documents reflect the superseded 1987 regulations, so they do not deal adequately with minimum distribution issues.

3.1 Commencement of Distributions

Article IV.3 of Form 5305 requires distributions from the IRA to begin by the IRA owner's required beginning date (RBD). Article IV.6 refers to the alternative method permitted by the regulations: If an individual has two or more IRAs, the total minimum required distribution (MRD) for all IRAs may generally be distributed from any one of them.[13] However:

1. An IRA held by an individual as an owner can only be aggregated with other IRAs held by him or her as owner;
2. An IRA held by an individual as a beneficiary of a decedent can only be aggregated with other IRAs held by him or her as beneficiary of the same decedent;
3. An IRA may not be aggregated with a 403(b) plan; and
4. A distribution from a Roth IRA will not satisfy the MRD for a regular IRA or 403(b) plan.[14]

These rules modify Notice 88-38, without saying so. Under the Notice, all IRAs could be aggregated, regardless of whether the individual was the owner or a beneficiary.

The BDF should reserve the right to use the alternative method.

3.2 Amount and Duration of Distributions

With reference to distributions to be made over a specified period not exceeding the IRA owner's life expectancy, or the joint and survivor life expectancy of the owner and the designated beneficiary, Article IV.3 of Form 5305 requires "equal or substantially equal annual payments." Article IV.4 has a similar provision for distributions to beneficiaries. The BDF should clarify that more frequent distributions are permissible and that, at any time, the owner (and, if so desired, a beneficiary) may withdraw more than the minimum.

3.3 Owner's Death Before the RBD

If the IRA owner dies before the RBD, Article IV.4(b) of Form 5305 provides that the beneficiary will elect the method of distribution, unless the owner has elected otherwise. If the owner does not wish the beneficiaries to have control over the distribution method, the election should be made by the owner and, again, the BDF appears to be the ideal place to do so.

4. Designation of a Trust as Beneficiary

If a trust is a beneficiary, the trust must be read carefully to ensure that none of its provisions are

inappropriate. The trust should include language that deals specifically with receipt of the IRA assets, such as directions for allocating the IRA proceeds between the marital deduction portion and the credit shelter portion.

4.1 Issues Under the Minimum Distribution Rules

If a trust is named as beneficiary of an IRA, the life expectancy of a trust beneficiary may be used in determining the permissible payout period only if the requirements of the regulations are satisfied.[15] If so, the beneficiaries of the trust will be "designated beneficiaries" for purposes of the minimum distribution rules.

Two additional rules must also be kept in mind. First, if there is more than one designated beneficiary, then unless separate accounts are established (see section 5.2 below), the maximum payout period is determined by reference to the designated beneficiary with the shortest life expectancy, i.e., the oldest.[16] Second, if any beneficiary (other than a qualifying trust or a "contingent beneficiary") is not an individual, the IRA owner will be treated as having no designated beneficiary.[17]

(a) Trust Beneficiaries as Designated Beneficiaries

If a trust is named as beneficiary of an IRA, then in order for the beneficiaries of the trust to be "designated beneficiaries," the following requirements must be met during any period for which MRDs are being determined by treating the trust beneficiaries as designated beneficiaries:[18]

(1) The trust is a valid trust under state law, or would be but for the fact that there is no corpus.

(2) The trust is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner (e.g., a testamentary trust).

(3) The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the IRA are identifiable from the trust instrument.

(4) The following documentation has been provided to the "plan administrator" (see (e) below).

(A) Required Distributions Commencing Before Death[19]

The IRA owner must comply with either (1) or (2):

(1) The owner provides to the "plan administrator" a copy of the trust instrument and agrees that, if the trust instrument is amended at any time in the future, the owner will, within a reasonable time, provide to the plan administrator a copy of each such amendment; or

(2) The IRA owner

(i) Provides to the plan administrator a list of all of the beneficiaries of the trust (including contingent and remainder beneficiaries, with a description of the conditions on their entitlement);

(ii) Certifies that, to the best of the owner's knowledge, this list is correct and complete and that the requirements of paragraphs (1), (2) and (3) above are satisfied;

(iii) Agrees to provide corrected certifications to the extent that an amendment changes any information previously certified; and

(iv) Agrees to provide a copy of the trust instrument to the plan administrator upon demand.

(B) Required Distributions After Death[20]

By the end of the calendar year following the year in which the owner dies, the trustee of the trust must either:

(1) Provide the plan administrator with a final list of all of the beneficiaries of the trust (including contingent and remainder beneficiaries, with a description of the conditions on their entitlement) as of the end of the calendar year following the year in which the owner died; certify that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of (a)(1), (2) and (3) above are satisfied; and agree to provide a copy of the trust instrument to the plan administrator upon demand; or

(2) Provide the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the IRA as of the end of the calendar year following the year in which the owner died.

(b) Who Are the Beneficiaries of a Trust?

As set forth above, it is necessary to identify the beneficiaries of the trust (1) to ensure that all trust beneficiaries are identifiable, (2) because all beneficiaries must generally be individuals and (3) to determine which beneficiary has the shortest life expectancy. However, the regulations do not define who **are** the beneficiaries of a trust, who must be scrutinized for purposes of this test.

In determining who are beneficiaries, for purposes of determining whether all beneficiaries of the trust are individuals, and in determining which beneficiary has the shortest life expectancy, the proposed regulations require you to disregard any person "whose entitlement to an employee's benefit is contingent on the death of a prior beneficiary."[21]

(c) Who Is a Contingent Beneficiary?

In general, if a beneficiary's entitlement is contingent on an event other than the death of the employee (or IRA owner), or the death of another beneficiary, that beneficiary is a designated beneficiary for purposes of determining which designated beneficiary has the shortest life expectancy.[22]

However, if the subsequent beneficiary is entitled to a benefit only if another beneficiary dies before the entire benefit to which that other beneficiary is entitled has been distributed, the subsequent beneficiary will not be considered a beneficiary for purposes of determining (1) which beneficiary has the shortest life expectancy or (2) whether a person who is not an individual is a beneficiary. This rule does not apply if the other beneficiary dies before the applicable date for determining the designated beneficiary.

If the designated beneficiary whose life expectancy is being used to calculate the distribution period dies on or after the applicable date, his or her remaining life expectancy will be used to determine the distribution period, regardless of whether a beneficiary with a shorter life expectancy receives the benefits.[23]

If, after the end of the calendar year following the year of the IRA owner's death, any person has the discretion to change the beneficiaries then, for purposes of determining the distribution period after death, the IRA owner is treated as having no designated beneficiary. This rule does not apply if a beneficiary has only the right to designate a beneficiary of any portion of the benefit that has not been distributed when the beneficiary dies.[24]

Under a typical QTIP trust, the children are considered beneficiaries:

> Because some amounts distributed from [the decedent's] account in Plan X to Trust P may be accumulated in Trust P during [the surviving spouse's] lifetime for the benefit of [the decedent's] children, as remaindermen beneficiaries of Trust P, even though access to those amounts are (sic) delayed until after [the surviving spouse's] death, [the decedent's] children are beneficiaries of [the decedent's] account in Plan X in addition to [the surviving spouse] and [the surviving spouse] is not the sole beneficiary.[25]

If the remainder beneficiary is a charity, rather than individuals, the result is potentially disastrous, as the decedent is then deemed to have no designated beneficiary.[26]

The rules under the new regulations are different from those contained in the 1987 regulations,[27] but are consistent with IRS's interpretation of the prior rule.[28]

The major area of concern with respect to this rule is where the secondary beneficiary is a charity because, under the IRS interpretation, the interest of the charity is not contingent. In view of these uncertainties, great care must be taken in naming charities as beneficiaries of IRA interests.

(d) Private Letter Ruling 98-20-021

In Private Letter Ruling 98-20-021, a trust (Trust M) was the named beneficiary of the decedent's profit sharing plan benefits. The primary beneficiary of the trust was the surviving spouse (B) and, on her death, trust assets were to be distributed to three charities. The pertinent sections of the ruling read as follows:

> 21 Trust M does not provide that Individual B must receive all amounts that are distributed from Plan X to Trust M. Although Individual B is entitled to income, and principal subject to a standard, Trust M does not require Individual B to receive any minimum distribution amount under section 401(a)(9) that has been distributed to Trust M, if greater than annual income. Further, any larger amounts requested by Trust M from Plan X that are allowed by Trust M's election are not required to be distributed to Individual B. **Thus, Plan X may distribute to Trust M an amount greater than Individual B is entitled to receive under Trust M during Individual B's lifetime**.
>
> 22 Because additional amounts that are distributed from Plan X could remain in Trust M during Individual B's lifetime, three organizations (not individuals), University Q, School R and Reservation S, **are entitled to benefits while Individual B is alive**

> unless the trustee of Trust M considers the amounts necessary for Individual B's health and medical needs, even though access to these amounts may be delayed until after Individual B's death. Absent the occurrence of this contingency, the death of Individual B **affects the timing rather than the availability of their benefits**. Thus, the entitlement of University Q, School R and Reservation S **is not contingent on the death of Individual B**. As a result, **these beneficiaries are designated beneficiaries** for purposes of applying the rules in section 1.401(a)(9)-1, Q&A E-5 and Individual B is not treated as the sole beneficiary. Pursuant to section 1.401(a)(9)-1 Q&A D-2A(b) of the proposed regulations Individual A **is treated as having no designated beneficiary** for purposes of section 401(a)(9) of the Code, since persons other than individuals are designated as beneficiaries of Individual A's account [Emphasis added].[29]

(e) Who Is the "Plan Administrator" of an IRA?

For a qualified plan, compliance with the minimum distribution rules is a qualification requirement,[30] so there is good reason to require the trust to provide documentation to the plan administrator, to enable the plan administrator to satisfy itself that the requirements are satisfied. The 1987 regulations gave no guidance as to who was the plan administrator of an IRA.

Under the new regulations, the trustee, custodian or issuer of the IRA is treated as the plan administrator for this purpose.[31]

(f) Perpetual Trusts as IRA Beneficiaries

A hotly debated issue is whether a perpetual or dynasty trust is a permissible beneficiary of IRA or qualified plan benefits. One view is that this is not allowed, because a trust that extends beyond the life expectancy of any living individual does not qualify as a designated beneficiary for purposes of the minimum distribution rules.[32] The other view is that such a trust is a permissible beneficiary, because use of the life expectancy method of payment is not conditioned on a showing that the benefits are being paid (or will be paid) to particular individual beneficiaries. The designated beneficiary must be identifiable, but the ultimate recipients of the benefits need not be.[33]

(g) Taxes and Expenses

Some commentators take the position that, if a trust is named as beneficiary of an IRA, the trust should affirmatively provide that IRA benefits cannot be used to pay estate taxes, debts or expenses of estate administration or IRS will assert that the estate is a beneficiary under the trust and thus there is no designated beneficiary.[34]

According to Virginia Coleman:

> The latest word we have is that if estate taxes are imposed on a plan or IRA under applicable law (e.g., a state apportionment statute), the estate will not on account of this be treated as a beneficiary. If, however, the instrument says anything about paying death taxes, even if it simply tracks what the law would otherwise provide, the estate will be treated as a beneficiary of the plan or IRA except if the plan or IRA cannot be used for this purpose by the terms of the instrument.[35]

4.2 Marital Deduction Issues

(a) In General

If the beneficiary is a trust, rather than the IRA owner's spouse, and the disposition is intended to qualify for the marital deduction, the same language that would be included in a marital deduction trust, to ensure qualification for the marital deduction, should be included in the BDF, e.g., allowing the surviving spouse to direct investments or requiring the trustee to obtain investments which produce a reasonable current income.[36]

IRS recently issued Revenue Ruling 2000-2,[37] which deals with the interplay of the minimum distribution rules and the estate tax marital deduction rules, where the beneficiary is a QTIP trust.

The facts described in the ruling were as follows: The IRA owner (A) died at the age of 55, survived by his or her spouse (B), who was 50 years old. A named the trustee of a testamentary trust as the beneficiary of the IRA. A copy of the trust and a list of the trust beneficiaries were provided to the custodian of A's IRA within nine months after A's death. As of the date of A's death, the testamentary trust was irrevocable and was a valid trust under the laws of the state of A's domicile.

Under the terms of the testamentary trust, all trust income is payable annually to B, and no one has the power to appoint trust principal to any per-

son other than B. A's children, who are all younger than B, are the sole remainder beneficiaries of the trust. No other person has a beneficial interest in the trust. Under the trust, B has the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to the income earned on the assets held by the IRA during the year, and to distribute that amount through the trust to B.

The trustee of the testamentary trust elects to receive annual minimum required distributions over B's life expectancy. On B's death, any undistributed balance of the IRA will be distributed to the testamentary trust over the remaining distribution period.

The IRS noted that the IRA is payable to a trust, the terms of which entitle B to receive all trust income, payable annually. In addition, no one has a power to appoint any part of the property in the trust or the IRA to any person other than B. Therefore, the IRS said, whether A's executor can elect to treat the trust and the IRA as QTIP depends on whether B is entitled to all the income for life from the IRA, payable at least annually.

Under the terms of the testamentary trust, B is given the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all the income earned on the assets held in the IRA and to pay that amount to B.

The IRS ruled that B's power meets the standard set forth in Treasury Regulation § 20.2056(b)-5(f)(8) for the surviving spouse to be entitled to all the income for life payable annually.[38] Thus, B has a qualifying income interest for life within the meaning of section 2056(b)(7) in both the IRA and the testamentary trust. Because the trust is a conduit for payments from the IRA to B, A's executor needs to make the QTIP election under section 2056(b)(7) for both the IRA and the testamentary trust.

In order to take advantage of Revenue Ruling 2000-2, it is necessary to be able to determine the amount of the IRA's income for the year in question.[39] The best approach would be to define "income" in the IRA document, rather than leaving this to the vagaries of state law. It is also advantageous to be able to claim that amounts withdrawn from the IRA are income rather than principal. Michael Jones suggests: "Consider providing that all withdrawals from the IRA, including withdrawals made under the minimum distribution rules, will be paid first from current and accumulated income of the IRA, then from IRA principal."[40]

The Uniform Principal and Income Act was recently adopted in New York.[41] The Act authorizes a trustee to adjust between principal and income, if the trustee determines that such an adjustment would be fair and reasonable to all of the beneficiaries.[42] The Act also provides with respect to IRAs and retirement plans that:

> If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income ten percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this paragraph, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.[43]

(b) Non-Citizen Spouses[44]

If the IRA owner's surviving spouse is a non-citizen, a marital deduction will be allowed in the owner's estate only if the benefits pass to a qualified domestic trust (QDOT).[45] An IRA can qualify for both QTIP and QDOT treatment.[46] Special rules apply if the surviving spouse becomes a citizen after the IRA owner's death.[47]

4.3 Issues Under New York Law

EPTL 13-3.3 deals with the designation of a trustee to receive certain proceeds, including pension and retirement plan benefits, and requires that the trust so designated must either (1) be in existence on the date of the designation or (2) be a testamentary trust. This section does not specifically refer to IRAs. The Committee recommends that the law be amended to provide specifically that it does apply to IRAs.

5. Additional Planning Issues During the Owner's Lifetime

5.1 Disability or Incompetence of the IRA Owner

Increased longevity carries with it an increased risk that an IRA owner may become incapable of making decisions with respect to the account, temporarily or permanently. Accordingly, in the case of any client with a substantial IRA balance, the appointment of an agent to make necessary decisions (such as changes of investments, transfer of the IRA to a new sponsor, electing a distribution method or changing the beneficiaries) should be considered. It may be appropriate to appoint different people to make different decisions.

There are at least two ways of appointing an agent. If the agent is to have limited, easily defined responsibilities, such as making investment decisions, then the easiest approach is probably to make the appointment in the BDF. The appointment should be consistent with the provisions of the owner's other estate planning documents so that, for instance, if a particular investment advisor is responsible for investing the assets of an *inter vivos* or testamentary trust, it would normally be appropriate to appoint the same person to direct the investment of the IRA assets.

If the agent's authority is to be more wide-ranging, then it would be preferable to use a durable power of attorney (DPA) that complies with the requirements of section 5-1501 of the General Obligations Law (GOL). The DPA should be a separate document from the BDF, as the DPA may need to be shown to parties who have no business knowing the dispositive provisions of the BDF.[48]

The statutory short form DPA lists, among the categories of transactions that the agent may be authorized to perform, "Retirement benefit transactions" and "Tax matters." The scope of each of these categories is further defined in the statute. The statutory definition will often not coincide with the scope of the authority that the owner wishes to confer, so the DPA should be modified as necessary. For example:

Retirement benefit transactions include withdrawing funds from the account, without limit; selecting and changing payment options; exercising any elections; and doing any other act that the owner can do through an agent.[49] The agent can also designate a beneficiary. However, the agent may not name himself or herself unless (1) the agent is a spouse, child, grandchild, parent or sibling of the owner or (2) the DPA permits the agent to designate himself or herself. The statute does not limit the ability of the agent to name anyone else, such as his or her spouse or child.

Tax matters includes preparing, signing and filing any tax-related documents and exercising any election available to the owner under federal, state or foreign tax law.[50]

It is important to coordinate the BDF and the DPA, to ensure that there are no inconsistencies in the client's plan.

5.2 Separate Accounts

Separate accounts are a response to two difficult rules under the proposed minimum distribution regulations: first, the rule that if there is more than one designated beneficiary, the beneficiary with the shortest life expectancy (i.e., the oldest one) is used to determine the maximum payout period;[51] and second, the rule that if any beneficiary is not an individual, there will be no designated beneficiary.[52]

One response to these rules is to establish totally separate IRAs. However, it may be more efficient and cost-effective to establish separate accounts under a single IRA. Under the proposed regulations, the general rule is that separate accounts will be aggregated for purposes of testing compliance with the minimum distribution rules.[53] However, if the beneficiaries of a separate account are different from the beneficiaries of other separate accounts of the owner, then the separate account need not be aggregated with the other accounts.[54]

Under the proposed regulations, a separate account within an IRA is a portion of the benefit "determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro rata basis in a reasonable and consistent manner between such portion and any other benefits."[55] This can be a fractional interest or a separate account. The amount of each separate account will be separately determined for purposes of determining the amount of the minimum distribution.[56]

As Virginia Coleman has noted, "it is unclear whether separate accounts must be established pursuant to the beneficiary designation, as opposed to under an outside trust."[57]

The BDF should make it clear that, notwithstanding the establishment of separate accounts, the IRA owner can withdraw funds during his or her lifetime from any or all of the accounts.

Another use for separate accounts, unrelated to the minimum distribution rules, is to ensure that the amount passing to a grandchild does not exceed the amount of the remaining generation-skipping tax (GST) exemption. Under the regulations, the GST exemption may not be allocated to a separate account during the IRA owner's lifetime.[58]

6. Planning for Events After the IRA Owner's Death

The following are some issues that can be problematic after the death of the IRA owner, and that are not addressed, or are not addressed satisfactorily, in the typical IRA document. The IRA owner should at least consider addressing these issues in the BDF.

6.1 Method of Payment of Death Benefits

Who chooses the form in which the remaining benefits are paid on the IRA owner's death, the IRA owner or the beneficiary? Many IRA documents give

this right to the beneficiary, or allow the beneficiary to withdraw the entire balance at any time. This may not be the IRA owner's intent. Presumably, in most cases, the owner will not want the IRA paid out faster than the other assets left to his or her heirs, and in some cases may want slower distributions to maximize the tax deferral.

If the beneficiary has the right to withdraw the entire account balance at any time, this is a general power of appointment and would result in the IRA balance being included in the beneficiary's gross estate if he or she dies before the account is exhausted.[59] This is not a problem if the beneficiary is the IRA owner's surviving spouse and the entire IRA qualifies for the marital deduction in the IRA owner's estate, or if the beneficiary's estate will not be subject to estate tax. Otherwise, the power to withdraw should be limited or conferred on a third party, if inclusion of the entire value in the beneficiary's gross estate is not desired.

6.2 Death of the Primary Beneficiary

If the primary beneficiary dies before the IRA is exhausted, who receives the remaining benefits, the contingent beneficiaries named by the IRA owner or a beneficiary named by the primary beneficiary? If the latter, what happens if the primary beneficiary fails to do so effectively? There is no reason in principle why the beneficiary should not be allowed to name beneficiaries, if this is the IRA owner's wish.[60] However, as with a will or trust, the BDF should attempt to provide for all possibilities, even if they appear unlikely to happen.

In a recent letter ruling, the IRS approved the designation of a beneficiary by the primary beneficiary, the son of the original IRA owner. The deceased mother's BDF effectively determined the maximum period of payments, but did not name a beneficiary to receive the balance if her son died before the end of that period. The IRS noted that allowing the son to designate a beneficiary did not extend the maximum payout period.[61]

The choice of primary and contingent beneficiaries, and the possibility of different contingent beneficiaries in different situations, requires the same degree of care as the corresponding provisions in a will or trust.

The fact that benefits are paid outright to the participant's spouse does not mean that the participant's estate automatically qualifies for the marital deduction. If the spouse does not survive until the participant's benefits have been completely distributed, care must be taken to ensure that the interest passing to the spouse is not a nondeductible terminable interest.

6.3 Transfer of the IRA

After the death of the IRA owner, can a beneficiary transfer the IRA assets (or his or her share of the assets) to another IRA in the name of the decedent? The decision on this issue should again be consistent with the owner's decisions with respect to the other estate planning documents. For instance, if the owner wants responsibility for investment to rest with someone other than the beneficiaries, the owner may not want to give the beneficiaries this right.

A transfer may be desirable for several reasons: for instance, because the beneficiary has moved to another state; or because another state's law provides greater creditor protection;[62] or to meet a beneficiary's preferences. The IRA documents should provide that the BDF continues to be effective for the new IRA.

6.4 Simultaneous Death

As with a will or trust, the order of deaths can directly affect the distribution of benefits from the IRA. Accordingly, the BDF should specify the presumptions that are to apply in the event of simultaneous death.

6.5 Governing Law

Form 5305 does not (but the IRA documents generally will) specify which state's law governs their interpretation. That will typically be the state in which the IRA sponsor is incorporated or headquartered. If that is not the state where the IRA owner lives, it may be appropriate to specify that the interpretation of the BDF will be governed by the law of his or her state of residence.

6.6 Execution of the IRA Documents

Particularly if the IRA documents establish a custodial account rather than a trust, it may be necessary (and is probably prudent) to execute the BDF with the same formalities as would be required for a valid will.

EPTL 13-3.2 deals with the rights of named beneficiaries of annuity or insurance policies and pension, retirement, death benefit, stock bonus and profit sharing plans. The statute provides that ". . . the rights of persons so entitled or designated and the ownership of money, securities or other property thereby received shall not be impaired or defeated by any statute or rule of law governing the transfer of property by will, gift, or inheritance."[63] A designation that is to take effect on death (of the person making the designation or another) must be written, signed[64] and (1) in the case of insurance, agreed to by the insurer or (2) in the case of a plan, agreed to by the employer or made in accordance with the plan's rules.[65]

Most IRA documents provide for a default beneficiary (e.g., the surviving spouse, if any, followed by surviving issue or, if none, the IRA owner's estate) if the IRA owner dies without a valid beneficiary designation. Clearly, the default designation is not signed by the IRA owner, and the statute should be amended to clarify that the default designation is valid despite the lack of a signature.[66]

EPTL 13-3.2 does not specifically state that IRAs are subject to its provisions, though cases have so held.[67] The statute should be amended to clarify that this is so. In addition, the statute does not specify how to revoke such a designation, or whether the designation can be revoked by will. The statute should be amended to clarify these issues.

New York State law also does not specify how an IRA beneficiary may designate his or her own beneficiary of an inherited IRA under state law. EPTL 13-3.2 should be amended to address this issue.

6.7 Disclaimers

As with any other dispositive document, provision for a disclaimer can provide increased flexibility and allow for postmortem planning. The IRA owner should consider including in the BDF a specific provision for disclaimer of all or part of the benefit, particularly if the primary beneficiary is the surviving spouse. The BDF should also state specifically who is to be the beneficiary of any benefit that is disclaimed.

The rules of the I.R.C. § 2518 do not entirely govern the effect of a qualified disclaimer for purposes of the minimum distribution rules. In Private Letter Ruling 94-50-040, the IRS ruled that it would not be appropriate to treat the disclaiming surviving spouse as dead, since she was still alive. In Private Letter Ruling 95-37-005, IRS treated the disclaimer as being equivalent to a change of beneficiary made by the participant (who was past his RBD) at the moment of death.

In Private Letter Ruling 2000-10-055, the IRS ruled that minimum distributions to a disclaimer trust were measured by the disclaiming widow's life expectancy, as she was the oldest beneficiary of the trust.

In Private Letter Ruling 2000-13-041, the IRS ruled that the personal representative of a man who died a few days after his wife properly disclaimed his interest in her IRA, and that their children could take distributions over the oldest child's life expectancy.

6.8 Minor Beneficiaries

The BDF should also provide for the possibility that a primary or contingent beneficiary may be a minor, or otherwise lack capacity, by specifying to whom the benefits should be paid in that situation. For example, the BDF could provide that the benefits will be paid to the natural or legal guardian.

6.9 Tax Clause

I.R.C. §§ 2206, 2207, 2207A and 2207B deal with who should bear the estate tax attributable to inclusion in the gross estate of property subject to a power of appointment, QTIP property, life insurance proceeds or retained-interest property. There is no corresponding provision for retirement benefits. In the absence of a provision in the IRA owner's will, or under state law, the IRA beneficiary is apparently not liable to pay the tax.[68]

Good estate planning may suggest, in a particular case, that a tax clause should be included in the BDF. However, this may cause problems under the current IRS interpretation of the minimum distribution rules: see section 4.1(g) above. Until this issue is resolved, it appears to be safer not to address the issue in the BDF.

Any tax clause should be both in the will and in the BDF. If the source of funds to pay the tax will or may be the IRA, the BDF should authorize distribution of the amount of taxes attributable to the IRA, as determined by the executor. The tax clause should also allow the beneficiaries of the IRA to pay their share of the tax from their own funds, to preserve the tax deferral potential of the IRA.

7. Additional Legal Issues

7.1 Compliance With the IRA Sponsor's Procedural Requirements

IRA documents, like insurance policies and retirement plans, typically require a beneficiary designation to be delivered to the appropriate person (here, the IRA sponsor) in order for it to be effective. In several cases, New York courts have held that the institution can waive compliance with its procedural requirements so that, in some of the cases, benefits passed under the decedent's will rather than under the beneficiary designation.[69]

The test applied by the courts is a facts and circumstances test, so this introduces uncertainty and increases the risk of litigation. Consideration should be given to including in the BDF a statement as to whether the IRA owner reserves the right to alter the beneficiaries by a later will and, if so, an agreement by the sponsor to waive its procedural requirements in that case. If, as one assumes would normally be the case, the IRA owner does not reserve that right, the BDF could require the IRA sponsor not to waive the procedural requirements so that a designation by

will would be ineffective unless the will is delivered to the IRA sponsor.

7.2 Spousal Rights

IRAs are not subject to the qualified joint and survivor annuity and qualified pre-retirement annuity rules that apply to qualified plans under ERISA and the I.R.C. Under state law, EPTL 5-1.1-A(b)(1)(G) includes "thrift, savings, retirement, pension, deferred compensation, death benefit, stock bonus or profit-sharing" plans and accounts as testamentary substitutes that are subject to the spouse's right of election. The statute does not specifically refer to IRAs, and should be amended to clarify whether it does so. From a policy viewpoint, there is no reason to exclude IRAs.

A retirement benefit will not be classified as a testamentary substitute if the decedent designated the beneficiary on or before September 1, 1992, and has not changed the beneficiary thereafter.[70]

7.3 Effect of Divorce

Numerous recent cases have addressed the following situation: A participant in an employer-sponsored plan, or owner of an insurance policy, designates his or her spouse as beneficiary. The parties are later divorced, but the beneficiary designation is never changed. Who receives the proceeds?[71] One way to address this issue is to specify in the property settlement agreement who is to receive any IRA proceeds, identifying each account individually. Another, and probably better, way is to specify in the BDF whether any designation of a spouse as beneficiary is to survive a divorce or separation.

Endnotes

1. The principal author of this report was David Pratt. Thanks to Kathleen Franklin and Ira Bloom for helpful comments on an earlier draft of the report.
2. The bibliography includes a (by no means complete) list of materials that address different aspects of the topic. In this report, works listed in the bibliography are cited by the name of the author, followed by "Bibliography #."
3. There are exceptions. First, a person who separated from service before 1985 may qualify for an estate tax exclusion, which would be lost if benefits were rolled over from a qualified plan to an IRA. *See* Priv. Ltr. Rul. 92-21-030; Rev. Rul. 92-22, 1992-1 C.B. 313. Second, a rollover may not be advisable for a person who has made a valid election under section 242(b)(2) of TEFRA. *See* Prop. Treas. Reg. § 1.401(a)(9)-8, Q&A 13, 16; Priv. Ltr. Rul. 96-17-048, 94-30-035, 93-10-026, 92-15-040, 90-42-063, 1999-08-060; I.R.S. Notice 83-23, 1983-2 C.B. 418.
4. Holt (Bibliography, #9) summarizes the pertinent features of 25 different IRA documents.
5. Natalie Choate & Lynn Asinof, *How to Handle an Inherited IRA Raises Some Thorny Questions*, Wall St. J., Oct. 22, 1998, at C1 (cites the case of a woman whose BDF was accepted by the custodian, but the custodian refused to honor it on her death).
6. In this report, reference is made to specific provisions of Form 5305. No separate reference is made to the provisions of Form 5305-A as the two forms are identical in all material respects.
7. Wilf, Bibliography #22.
8. *See E.F. Hutton & Co. v. Wallace*, (E.D. Mich. 1987), *rev'd and remanded*, 863 F.2d 472 (6th Cir. 1988). For purposes of I.R.C. § 408, it makes no difference whether the IRA is trusteed:

   > For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in subsection (n)) or another person who demonstrates, to the satisfaction of the Secretary or his delegate, that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an individual retirement account described in subsection (a). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof. [Code section 408(h)]

   Noel Ice agrees that there is a difference under state law:

   > There is a long and well established difference between a custodian and a trustee. It may be that both are fiduciaries, but their duties and powers are certainly not the same. I expect that this an area of developing law in which we will see new cases arise in the not too distant future. [Ice, Bibliography #13]

9. *See Leier v. Leier*, 524 N.W.2d 106 (N.D. 1994).
10. See section 6.6 below, discussing EPTL 13-3-2.
11. I.R.C. §§ 408(a)(6), (b)(3); Prop. Treas. Reg. §§ 1.401(a)(9)-1, Q&A 1, 1.408-8, Q&A 1.
12. 66 Fed. Reg. 3928 (Jan. 17, 2001).
13. Prop. Treas. Reg. § 1.408-8, Q&A 9.
14. *Id.*
15. Prop. Treas. Reg. §§ 1.401(a)(9)-4, Q&A 5, 1.408-8, Q&A 1(b).
16. Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(a)(1).
17. *Id.*
18. Prop. Treas. Reg. §§ 1.401(a)(9)-4, Q&A 5, 1.408-8, Q&A 1(b). The regulations also provide for the situation where the beneficiary of the named trust is another trust [Prop. Treas. Reg. § 1.401(a)(9)-4, Q&A 5(c)].
19. Prop. Treas. Reg. § 1.401(a)(9)-4, Q&A 6(a).
20. Prop. Treas. Reg. § 1.401(a)(9)-4, Q&A 6(b).
21. Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(c)(1).
22. Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(b).
23. Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(c)(2).
24. Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(d).
25. Prop. Treas. Reg. § 1.401(a)(9)-5, Q&A 7(c)(3), Ex. 2.
26. *See*, *e.g*, Priv. Ltr. Rul. 98-20-021.
27. *See* 1987 Prop. Treas. Reg. §§ 1.401(a)(9)-1, Q & A E-5(b), (e)(1).
28. Ice, Bibliography #14, at 239.
29. *See also* Priv. Ltr. Rul. 1999-12-041, 98-46-034, 98-48-032, 98-47-022.
30. I.R.C. § 401(a)(9).

31. Prop. Treas. Reg. § 1.408-8, Q&A 1(b). The preamble to the 1997 proposed regulations treats an IRA custodian as the equivalent of the plan administrator, but this provision did not appear in the text of the regulations.

32. *See*, *e.g.*, Choate, Bibliography #2, and Coleman, Bibliography #6.

33. *See*, *e.g.*, Ice, Bibliography #14, at 239-241.

34. *See*, *e.g.*, Coleman, Bibliography #6, at 142, and #34. *See also* Priv. Ltr. Rul. 2000-18-055, 2000-10-055, 1999-12-041.

35. Coleman, Bibliography #6, at 143. *See also* Ice, Bibliography #14, at 241.

36. *See* Treas. Reg. § 20.2056(b)-5(f)(4).

37. Rev. Rul. 2000-2, 2000-3 I.R.B. 305.

38. ". . . under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse or . . . she must have such command over the income that it is virtually hers. Thus, the conditions . . . are satisfied in this respect if, under the terms of the trust instrument, the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income" [Treas. Reg. § 20.2056(b)-5(f)(8)].

39. *See* Jones, Bibliography # 15, at 966.

40. *Id. See also* Goodwin, Bibliography #37.

41. A.4050, signed by the Governor on Sept. 5, 2001.

42. EPTL 11-2.3(b)(5), enacted by A.9050 § 1. The Act is effective January 1, 2002 [EPTL 11-A-6.3; of A.9050 § 10], and generally applies to trusts created before or after that date.

43. EPTL 11-A-4.9(c), enacted by A.9050 § 3. The trustee must allocate a greater amount to principal if this is necessary to obtain an estate tax marital deduction (EPTL 11-A-4.9(d)). The Act also provides for an optional unitrust provision (EPTL 11-2.4, enacted by A.9050 § 4).

44. *See generally* Choate, Bibliography #5.

45. I.R.C. § 2056(d). *See also* Choate, Bibliography #5, which includes suggested language for a QDOT.

46. *See*, *e.g.*, Priv. Ltr. Rul. 93-21-032, 93-22-005.

47. I.R.C. § 2056(d)(4).

48. For a sample power of attorney for retirement benefits, see Choate, Bibliography # 2, at 476-477.

49. GOL § 5-1502L.

50. GOL § 5-1502N.

51. Prop. Treas. Reg. § 1.401(a)(9)-5, Q & A 7(a). In Priv. Ltr. Rul. 1999-31-048 and 1999-31-049, the IRS ruled that multiple beneficiaries of one IRA could each use his or her own life expectancy to calculate minimum distributions, rather than all having to use the life expectancy of the oldest beneficiary. *See* Goldberg, Bibliography #8. In Priv. Ltr. Rul. 2000-11-072, the IRS ruled that beneficiaries may take retirement plan distributions over the oldest beneficiary's life expectancy, even though the participant took distributions based on his single, recalculated life expectancy.

52. *Id.*

53. Prop. Treas. Reg. 1.401(a)(9)-8, Q&A 2(a).

54. Prop. Treas. Reg. 1.401(a)(9)-8, Q&A 2(b).

55. Prop. Treas. Reg. 1.401(a)(9)-8, Q&A 3(a).

56. Prop. Treas. Reg. 1.401(a)(9)-8, Q&A 2(b).

57. Coleman, Bibliography #34 ; *see* Priv. Ltr. Rul. 2000-41-039 (recognizing separate trusts under a will as separate accounts), 1999-31-048, 1999-31-049 (holding that separate accounts were established), 1999-03-050 (holding no separate accounts); *see also* Priv. Ltr. Rul. 2000-52-042, 2000-52-043, 2000-52-044, 1999-03-905, 98-10-031.

58. Treas. Reg § 26.2632-1(c). An IRA would be considered a trust for GST purposes, even if it is a custodial IRA. I.R.C. § 2652(b)(1) provides that the term "trust" includes any arrangement (other than an estate) which, although not a trust, has substantially the same effect as a trust.

59. I.R.C. § 2041.

60. See Choate, Bibliography #3.

61. Priv. Ltr. Rul. 1999-36-052.

62. The Investment Company Institute has published a helpful guide showing the extent to which different types of IRAs are protected against creditors under the laws of each state. The guide can be downloaded from its Web site, www.ici.org.

63. EPTL 13-3.2(a).

64. *See Androvette v. Treadwell*, 73 N.Y.2d 746 (1988) (holding that an unsigned change of beneficiary was void).

65. EPTL 13-3.2(e). The requirement that the beneficiary designation be in writing was held to be preempted by ERISA with respect to an employer plan. *O'Shea v. First Manhattan Co. Thrift Plan & Trust*, 55 F.3d 109 (2d Cir. 1995).

66. *In re Trigoboff*, 175 Misc. 2d 370, 669 N.Y.S.2d 185 (1998) (the court did not suggest that the default designation in the IRA was invalid, but held that a testamentary disposition was better evidence of the decedent's intent).

67. *See*, *e.g.*, *In re Morse*, 150 Misc. 2d 415, 568 N.Y.S. 2d 689 (1991) (holding that a testamentary disposition of an IRA superseded a prior designation); *In re Trigoboff*, 175 Misc. 2d 370 (holding that a specific testamentary disposition of an IRA in a will pre-dating decedent's marriage superseded the IRA's generic default designation in favor of the surviving spouse).

68. I.R.C. § 2205. *See* Temp. Treas. Reg. § 54.4981A-1T, Q&A d-8A (dealing with the now-repealed excess accumulations tax).

69. *See*, *e.g.*, *McCarthy v. Aetna Life Ins. Co.*, 92 N.Y.2d 436 (1998).

70. EPTL 5-1.1-A(b)(1)(G).

71. For instance, in *McCarthy v. Aetna Life Ins. Co.*, 92 N.Y.2d 436, the decedent had named his ex-wife as beneficiary of an insurance policy. A later will left all "insurance proceeds" to his father, but the beneficiary designation was never changed. The court held that the ex-wife was entitled to the proceeds because there was insufficient evidence of an intent to change the beneficiary. In the context of an ERISA-covered pension or welfare plan, the situation is complicated by the anti-alienation and QDRO rules and the general preemption of state law. The 5th Circuit recently held that a Texas law, which generally invalidates a life insurance beneficiary designation in favor of a spouse upon the divorce of the participant and the spouse, was preempted by ERISA. *Manning v. Hayes*, 2000 U.S. App. LEXIS (5th Cir. 2000). The court applied federal common law in holding that the ex-wife was entitled to the proceeds. In *Egelhoff v. Egelhoff*, 2001 U.S. LEXIS 2458 (2001), the U.S. Supreme Court held that ERISA preempts a Washington State statute that revokes, on dissolution of marriage, a deceased's designation during marriage of his then-spouse as beneficiary of his pension plan and employer-provided life insurance.

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Note: "ALI-ABA" refers to ALI-ABA Course of Study Materials.
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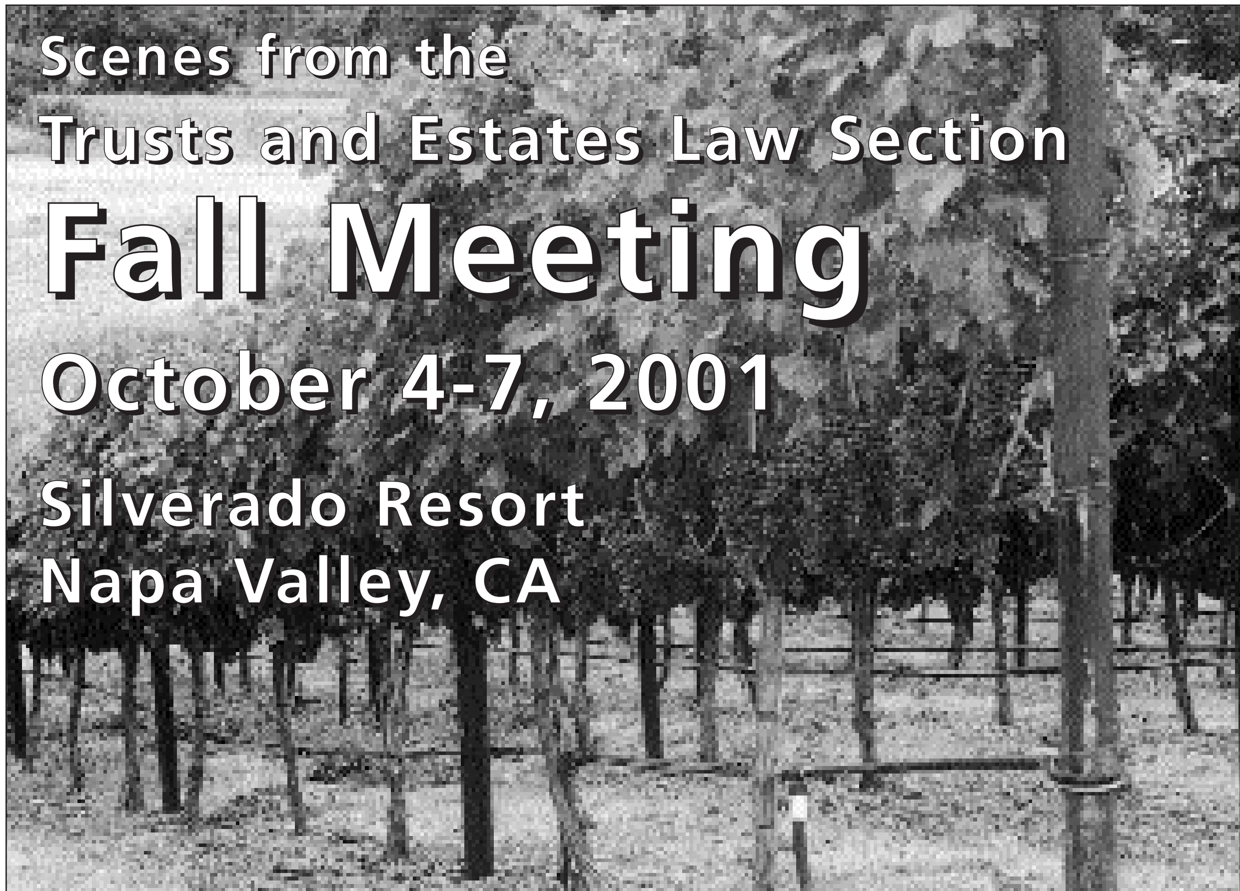
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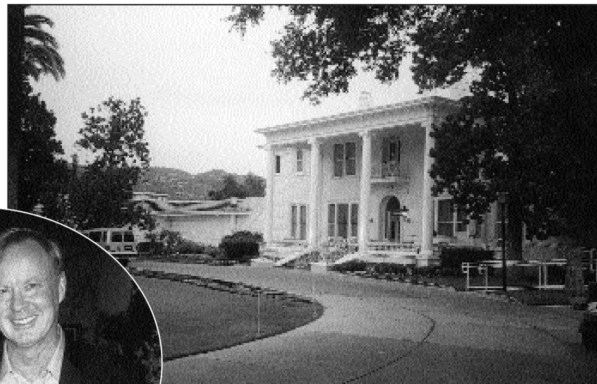
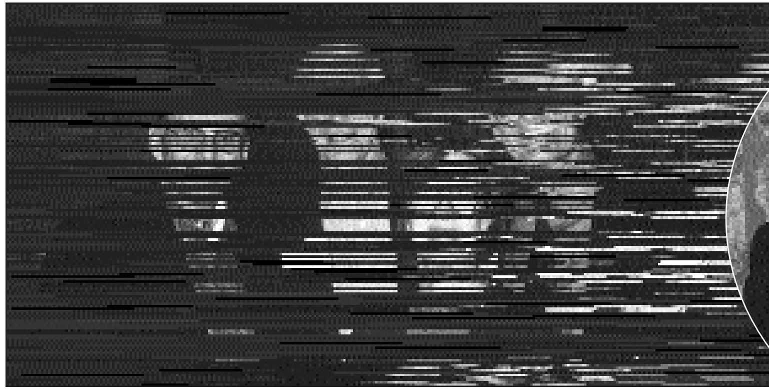
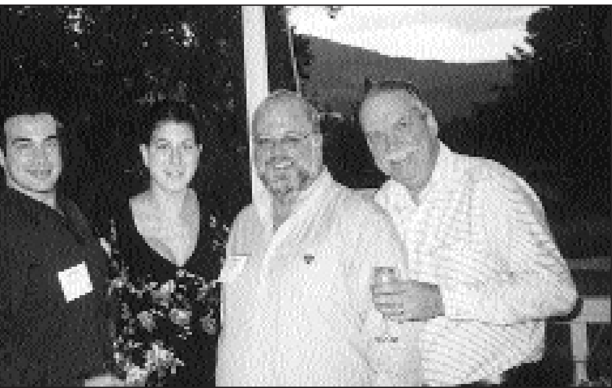
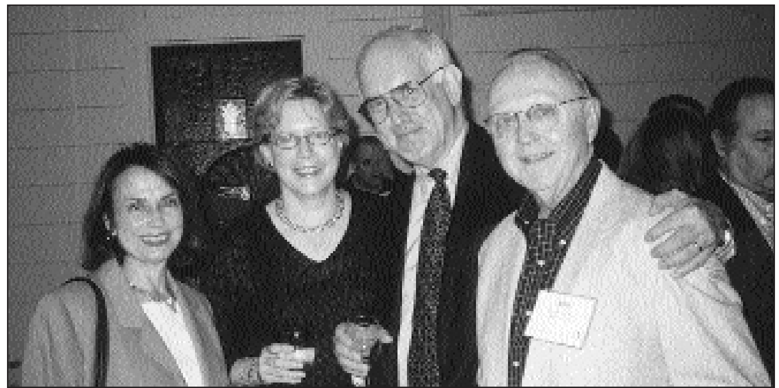
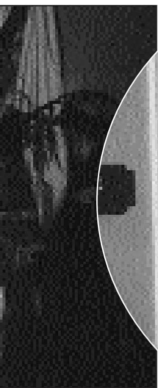
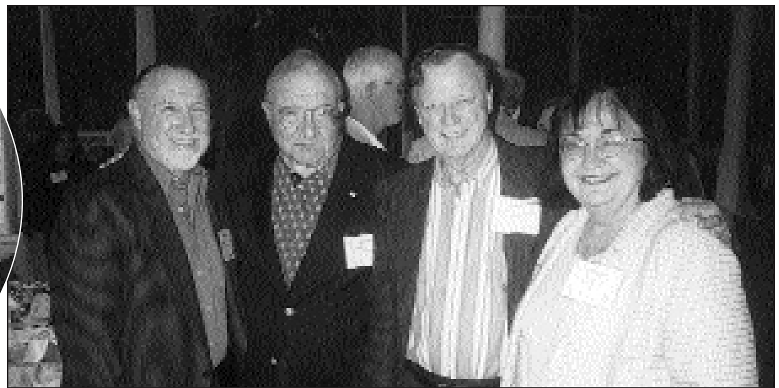
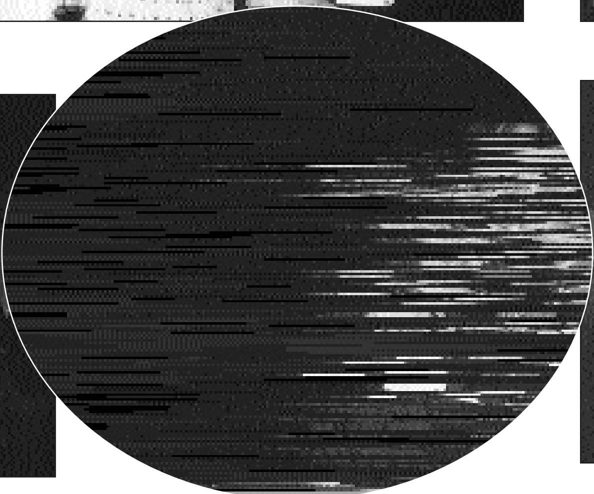
Fall Meeting
October 4-7, 2001
Silverado Resort
Napa Valley, CA









Legislation Status Affecting the Practice

By Ronald J. Weiss

As of mid-December 2001, there were over 50 bills pending in the New York State Senate and Assembly that effect the trusts and estates practice. A resource for keeping track of pending bills is the Assembly's Web site (assembly.state.ny.us/leg), which is searchable both by bill number and key word. The following is a summary of these bills.

Bill Number	Description
A.13 (similar to S.227)	Prohibits a service charge or minimum balance requirement for attorney trust or IOLA accounts.
A.126 (same as S.1913)	Prohibits persons found guilty of homicide by reason of mental disease or defect from receiving a decedent's property by will or interstate succession.
A.212 (same as S.438)	Includes the value of all property received, real or personal, other than specifically bequeathed/devised property, in computing the commissions of certain fiduciaries.
A.307	Provides a $1,000 credit against the New York estate tax for organ donors.
A.377 (same as S.2858)	Broadens the information to be supplied from the statewide register of child abuse and maltreatment when applying for letters of guardianship.
A.765	Relates to the legal rights of a child conceived after the death of his or her parent through artificial means.
A.1165 (same as S.192)	Authorizes guardians of incompetent persons and fiduciaries appointed by a surrogate's court to be included as qualified persons under Public Health Law § 18 eligible to request access to medical records.
A.1330 (same as S.3366)	Makes provision for orders for the purpose of performing paternity testing on a decedent.
A.1437 (same as S.1083)	Enacts fiduciary privilege bill relating to the effect of death or disability on certain privileges and requires disclosure to courts of certain communications. (Vetoed 11/13/01.)
A.2261 (same as S.5219)	Creates a rebuttable presumption in civil actions and in criminal actions for larceny that a disabled principal does not consent to certain transfers pursuant to a power of attorney.
A.2419	Enacts the "qualified dispositions in trust act" (would permit the creation of perpetual and creditor protection trusts).
A.2911 (same as S.2348)	Provides that certain supplemental needs trusts may be established without the payment of any medical assistance lien attached to the amount to be held in trust.
A.2956	Establishes certain trusts as void as against public policy where beneficiary's interest ceases if beneficiary needs medical, hospital or nursing care.
A.2995	Authorizes provision of support for a decedent's children under age 21 where decedent's will makes no reasonable provision for a child's maintenance and child's other parent is deceased.
A.3135	Authorizes disclosure of death of biological parents and of adoptive children by adoption registry.
A.3222	Provides that certain procedural requirements be met in order for a spouse to waive or release his or her right to a distributive share of the other spouse's estate.
A.3318	Authorizes a court to compensate guardians from amounts appropriated to the Department of Mental Hygiene if court finds that insufficient funds exist.

Bill Number	Description
A.4037	Provides for the revocatory effect of divorce on dispositions by will, death benefit or under lifetime trusts.
A.4221 (same as S.2320)	Relates to the rights of domestic partners, spouses, parents, siblings and close friends to control the disposition of a decedent's remains.
A.4242 (same as S.2310)	Permits the certification of a photographic reproduction of a will by an attorney for purposes of proving a will by affidavit of attesting witness out of court.
A.4317	Relates to the registration of charitable organizations with the Attorney General's office, requires a clear description of an organization's purpose and use of funds.
A.4440	Requires prior disclosure of income, assets and financial obligations of decedent to enforce a surviving spouse's waiver of his or her right of election; waives the dead man statute in such circumstances.
A.4447 (same as S.4782)	Relates to the commissions of corporate fiduciaries of charitable trusts.
A.4554 (same as S.261)	Amends NPCL § 720-a to limit the civil liability of directors and officers of not-for-profit corporations.
A.4608	Allows court to determine reasonable compensation for an attorney selected by an allegedly incapacitated person.
A.4739	Amends relevant provisions of the SCPA, Domestic Relations and Social Services Laws by replacing the phrase "natural parent" with "biological parent."
A.4743	Provides that for settlements that require a court order, the order shall provide for the payment of interest on the settlement amount at the statutory interest rate on judgments.
A.5523	Enacts the "Family Health Care Decision Act," establishing procedures for making health care decisions on behalf of patients unable to decide about treatment for themselves.
A.5658 (same as S.2784)	Makes provision preserving attorney-client privilege when the client is a "personal representative" vis-à-vis the beneficiaries of an estate.
A.6768 (same as S.1853)	Permits wrongful death action on behalf of child *in utero*.
A.7016	Excludes an individual's elective share of a deceased spouse's estate as an available resource for purposes of Medicaid eligibility.
A.7317 (see also S.794)	Makes changes with respect to the rule against perpetuities and powers of appointment in relation thereto.
A.7670 (same as S.1620)	Provides a right of action for persons killed or injured by illegally obtained handguns against the person providing or procuring such handgun.
A.7789 (same as S.793)	Expands the types of damages that may be awarded to the persons for whose benefit an action for wrongful death is brought to include emotional loss.
A.7791 (same as S.5461)	Makes provision with respect to the right to a jury trial in a contest of a revocable living trust and in the incorporation by reference in a will of a lifetime trust.
A.7792 (same as S.795)	Relates to the commissions of a trustee who qualifies on or after June 5, 1978 under the will of a decedent dying on or before August 31, 1956. (Signed 10/13/01; chapter 376).
A.7794	Relates to the appointment of guardians for the person/property of certain persons.
A.7944 (same as S.1389; see also A.3360)	Enacts the transfer-on-death security registration act.

Bill Number	Description
A.8357 (same as S.2936)	Amends SCPA 1411(3) to limit service of citation in a contested probate proceeding on only those persons named or referred to in a will who have appeared or whose interests would be adversely affected by the outcome of the proceeding. (Signed 10/13/01; chapter 393).
A.8466	Enacts "Health Care Decisions Act for Persons with Mental Retardation," authorizing guardian to make health care decisions for such persons lacking capacity.
A.8661 (same as S.4781)	Amends the Tax Law to phase out the distinction between resident and non-resident trusts.
A.8690 (same as S.5218)	Regulates possible conflicts of interest situations between officers or directors and the not-for-profit corporations they represent.
A.8774 (same as S.4395)	Provides that an adoptive child will not lose either inheritance rights or the right to receive lifetime dispositions from his or her natural parents.
A.8794 (same as S.5513)	Allows renunciation of property on behalf of a person under a disability to be made by a guardian or by an attorney-in-fact pursuant to a duly executed power of attorney.
A.9167 (see also A.7791)	Establishes a party's statutory right to trial by jury on a controverted question of fact in any proceeding for the determination of the validity of a lifetime trust.
S.669	Prohibits postmortem retrieval of sperm from a decedent unless the deceased gave written consent for such procedure prior to his death.
S.794	Enacts the Perpetual Trust Act of 2001.
S.2937	Amends EPTL 10-10.1 to authorize the grantor of a trust to confer upon trustees the power to make discretionary distributions to themselves as beneficiaries and to make discretionary allocations.
S.2938	Amends SCPA 2110 to permit certain expenses to attorneys in addition to compensation for legal services.
S.3367	Makes amendments to the statutory short form of durable general power of attorney.
S.3431	Relates to recognizing the legitimacy of children born to married couples by means of in vitro fertilization or any other assisted reproduction.
S.3698	Relates to the manner of investigation when decedent is a donor of an anatomical gift and the coroner or medical examiner deems the death suspicious.
S.4387	Provides that real property with a value of $50,000 or less may be included within the voluntary administration (SCPA Article 13) of a small estate.
S.4783	Relates to the liability of a trustee, other than a corporate trustee, for decisions of a delegee under the Prudent Investor Rule.
S.4894	Establishes legal rights in grandparents who act as guardian and custodian of their grandchildren.
S.5173	Provides for the indemnification of officers and directors of not-for-profit corporations and establishes the terms and conditions under which such indemnification may be accomplished.

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New York's New Principal and Income Act

By David J. Arcella

The Uniform Principal and Income Act (UPAIA) was promulgated by the National Conference of Commissioners on Uniform State Laws in 1997 and was amended in 2000 to include a section on judicial control for abuse of discretion.

The Act was a necessary complement to the Prudent Investor Act which encouraged trustees to manage their portfolios pursuant to risk and return objectives unhindered by the necessity of balancing portfolios for the sake of generating sufficient current trust accounting income. Dividend yields, for a variety of reasons, have subsided to levels as low as 1%, or in the case of many attractive growth stocks, none at all.

While the Uniform Act offers only the power to adjust, the New York Principal and Income Act has provided trustees with a choice of two "regimes," each of which is designed to enable the trustee to manage a trust portfolio as a prudent investor without the need for trust accounting income driving the portfolio asset allocation. Those two regimes are the power to adjust between principal and income (the default regime for existing and new trusts), and the 4% unitrust, (the optional regime for existing and new trusts).

Other states have responded to this evolving responsibility by enacting variations of the Uniform Act while in some cases drawing on the unitrust concept, either at a set percentage or allowing a trustee to choose a unitrust within a range of percentages.

The Connecticut Principal and Income Act effective January 1, 2000 adopted UPAIA, with minor variations, before the amendment of UPAIA providing for judicial control for abuse of discretion. However, an amendment adding judicial control was signed by the Governor on June 6, 2001.

California adopted a Principal and Income Act effective January 1, 2000, (Chapter 3, Part 4 CA Probate Code div. 9 Sec. 16320 *et seq.*) providing for a power to adjust with protection and notice. The California Act endeavors to protect the trustee from liability for failure to even consider use of the power: "Nothing in this section or in this chapter is intended to create or imply a duty to make an adjustment, and a trustee is not liable for not considering whether to make an adjustment or for choosing not to make an adjustment."

It also establishes a mechanism for serving beneficiaries with notice of a decision to exercise the power. If notice is properly served, and no objection is made within the required period, a cause of action is forever barred.

In the 2001 legislative session, Missouri, New York, New Jersey and Delaware have enacted principal and income statutes, and Pennsylvania has introduced a bill.

The approach of these states to the responsibilities of the power to adjust and the unitrust vary.

I. New Jersey Principal and Income Act

New Jersey has enacted a power to adjust but no unitrust.

It also has a safe harbor:

> A decision by a trustee *to increase* the distribution to the income beneficiary or beneficiaries in any accounting period *to an amount not in excess of four percent, or to decrease that period's distributions to not less than six percent*, of the net fair market value of the trust assets on the first business day of that accounting period shall be presumed to be fair and reasonable to all of the beneficiaries.

II. Pennsylvania Principal and Income Bill (Introduced at the time this article was written)

Section 8104. Pennsylvania, like New York has a power to adjust as a default, and a power to opt into a unitrust.

Section 8105. Power to convert to unitrust (4%).

> (a) Conversion—Unless expressly prohibited by the governing instrument, a trustee may release the power under section 8104 (relating to trustee's power to adjust) and convert a trust into a unitrust as described in this section if all of the following apply:
>
> (1) The trustee determines that the conversion will enable the trustee to better carry out the intent of the settlor or testator . . .
>
> (2) The trustee gives written notice of the trustee's intention to release the power to adjust and to convert the

trust into a unitrust and of how the unitrust will operate to all the *sui juris beneficiaries*.

III. Missouri

Missouri, too, has enacted a version of the Uniform Principal and Income Act which provides for a default power to adjust with an opt-in provision for a 3% unitrust, or such higher amount as is stated in the governing instrument.

IV. Delaware Title 12 DE Code § 3527(i)

This title has no power to adjust, but has established an optional power to convert to a unitrust.

A trustee may (i) convert an income trust to a total return trust (ii), reconvert a total return unitrust to an income trust, (iii), change the percentage used to calculate the unitrust, if

(1) the trustee adopts a written policy to that effect

(2) sends notice of the change to beneficiaries

(3) at least one person receiving the notice is legally competent.

(4) No person receiving notice objects within 60 days.

Interested trustees may appoint a disinterested person to determine the percentage payout in a total return trust.

The unitrust must be not less than 3% and not more than 5%.

The unitrust range within 3-5% is particularly appealing, since it not only offers the trustee the benefits of stepping back entirely from the burden and restraint of allocating receipts and disbursements between principal and income, but it tracks not coincidentally the range expressly deemed a reasonable definition of income by the Treasury Department's proposed regulations 1.643(b-1), and it enables trustees to select a unitrust of less than 4%. Many investment professionals believe that an annual payout as high as 4% holds the potential to do serious violence to the real value of a trust portfolio over a long period of time, particularly in the face of a serious and prolonged bear market.

Incidentally, the proposed regulations, if and when they become final, also permit, but do not require, the trustee to include gains from the sale or exchange of capital assets in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a *reasonable and consistent* exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by local law or by the governing instrument, if not inconsistent with local law):

(1) Allocated to income;

(2) Allocated to corpus but treated by the fiduciary on the trust's books, records and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but utilized by the fiduciary in determining the amount which is distributed or required to be distributed to a beneficiary.

Once the trustee decides to include capital gains in DNI with respect to discretionary distributions, he must do so consistently in future years.

V. The New York Principal and Income Act (The "Act") (signed into law on September 4, 2001)

The EPTL-SCPA Legislative Advisory Committee (LAC), the draftsmen of our New York Act, decided that it would be more appropriate to separate the power to adjust from the body of the Act and place it in EPTL 11-2.3, the N.Y. Prudent Investor Act (NYPIA). The reason for this, the author believes, is simple and sound.

> The Committee recommends removing the Section 104 (trustee's power to adjust) provision of the 1997 revised uniform principal and income act from the proposed New York version of the uniform act (EPTL 11-A,) and placing this provision instead within the framework of the New York prudent investor act (EPTL 11-2.3) as subparagraph (b)(5).
>
> This proposal considers that the appropriate place to authorize a trustee to make distribution decisions is in the prudent investor act rather than the principal and income act. The prudent investor act already defines a framework for "appropriate distributions," taking many specified factors into account. The proposed statutory discretion to make or not to make such distributions can be understood as part of the duty to "invest and manage property" in accordance with the prudent investor standard except to the extent a governing instrument provides otherwise, as set forth in EPTL 11-2.3(a).

Fifth Report, LAC, May 11, 1999

The new subparagraph (b)(5) as a result more clearly interlocks the prudent investor standard with the power to adjust, than does the Uniform Act.

The trustee may exercise the power "to the extent the trustee considers advisable to enable the trustee to make appropriate present and future distributions in accordance with [EPTL 11-2.3(b)(A)]." That subparagraph refers to distributions in accordance with risk and return objectives reasonably suited to the entire portfolio.

The trustee may do so *if the trust describes the amount that may or must be distributed by referring to the trust's income* and the trustee manages as a prudent investor, and determines, *after* applying the rules in EPTL 11-A, that such an adjustment would be fair and reasonable to all of the beneficiaries, so that current beneficiaries may be given use of trust property as is consistent with preservation of its value. The rules in EPTL 11-A really refer to the rules in EPTL 11-A-1.3, which are virtually identical to the Uniform Act and state:

Section 11-A-1.3. Fiduciary Duties: General Principles

(a) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of (the act), a fiduciary:

1. shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this Article;

2. may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this Article;

3. shall administer a trust or estate in accordance with this Article if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

4. shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust or the will and this Article do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising a discretionary power of administration regarding a matter with the scope of this Article, whether granted by the terms of the trust, a will, or this Article, *a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries*, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with the Article is presumed to be fair and reasonable to all the beneficiaries.

While the Uniform Act allows the trustee to adjust only if "the trustee is *unable* to comply with (the last above-stated paragraph in following the directions that precede it"), the New York Act merely requires the trustee to consider these issues before making a decision to adjust, which is a subtle difference.

In deciding whether to exercise the power, the trustee is referred back to the original standards of the NYPIA for the investment of trust assets, found in EPTL 11-2.3(b)(3)(B) and (4)(B).

The trustee may, as well, consider the following factors, (taken from the Uniform Act) to the extent relevant:

I. the intent of the settlor, as expressed in the governing instrument; the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor.

II. the net amount allocated to income under Article 11-A and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available; and

III. whether and to what extent the terms of the trust give the trustee power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income.

When a Trustee Can't Exercise the Power to Adjust

(C) A trustee may not make an adjustment:

(*Parentheses below are author's comments*)

I. that *diminishes* the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction is claimed; (the treasury's proposed regulations, if and

when they become final, probably make this provision unnecessary since an exercise of the power as defined by the regulations, which track the Uniform Act, satisfies the requirements of the marital deduction. However, the N.Y. Act, as written, does not permit transfers *from* income *to* principal in a trust that qualifies for the marital deduction).

II. that reduces (may increase, apparently, but not reduce) the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion.

III. that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust's assets;

IV. *from* (you can add to, but not take from) any amount that is permanently set aside for charitable purposes under a will or the terms of a trust *unless* the income therefrom is also permanently devoted to charitable purposes;

V. if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;

VI. if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;

VII. if the trustee is a current beneficiary or a presumptive remainderman of the trust; (*UPAIA just uses term "beneficiary."*)

VIII. if the trustee is not a current beneficiary or a presumptive remainderman, but the adjustment would benefit the trustee directly or indirectly; or (*This relates to distinction made in VII above. The author believes this allows a contingent remainderman/trustee to adjust from principal to income, but not the other way around. Furthermore, "directly or indirectly" refers to trustees with beneficial interests and is not intended to preclude a disinterested trustee from adjusting from income to principal merely because it may increase the commissionable base. Such a restriction would, in part, defeat the flexibility the power is designed to provide.)*

IX. if the trust is an irrevocable lifetime trust which provides income to be paid for life to the grantor, and possessing or exercising the power to make an adjustment would cause any public benefit program to consider the adjusted principal or income to be an available resource or available income and the principal or income or both would in each case not be considered as an available resource or income if the trustee did not possess the power to make an adjustment.

(D) If subparagraph (b)(5)(C)(V), (VI), (VII) or (VIII) applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust.

(E) A trustee may release the entire power conferred by clause (b)(5)(A) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power will cause a result described in subparagraph (b)(5)(C)(I) through (VI) or (b)(5)(C)(VIII) or if the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subparagraph (b)(5)(C). The release may be permanent or for a specified period, including a period measured by the life of an individual.

(F) Terms of a trust that limit the power of a trustee to make an adjustment between principal and income are not contrary to this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment conferred by subparagraph (b)(5)(A).

(*It won't be clear from the terms of a trust that predates the statute, since it cannot be construed that the grantor contemplated a power that did not exist, and then discarded it. Draftsmen of new trusts can expressly opt out of the power, but the power was designed to apply to pre-existing trusts that do not*

have the mechanisms in the document to distribute current return equitably in the face of modern portfolio theory.)

Abuse of Discretion and Judicial Control

(This section was added by the Commissioners on Uniform Laws and adopted by the states in order to encourage trustees to consider the power and reassure them that the standard by which they will be judged in the use of the power is the "abuse of discretion" standard, which affords trustees strong protection, and is further buttressed by creating an order that allows the trustee to transfer from the trust, or withhold from the unduly enriched beneficiary, to the extent possible, before surcharge is considered).

(A) A court shall not change a fiduciary's decision to exercise or not to exercise an adjustment power under the act unless it determines that the decision was an abuse of discretion.

(B) (Applicable to power to adjust under Act.)

(C) Authorization for court to remedy abuse of discretion.

If a court determines that a fiduciary has abused his, her or its discretion, *the court may** restore the income and remainder beneficiaries to the positions they would have occupied if the fiduciary had not abused his, her or its discretion, according to the following rules:

*(*UPAIA states that "the remedy is . . ." therefore the implication as viewed by some members of the Bar is that the remedies embraced in 1, 2 and 3 below in the Uniform Act were the only ones available. The New York language, in response to these concerns, was reworded.)*

1. To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or a distribution that is too small, the court shall require the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to his or her appropriate position.

2. To the extent that the abuse of discretion has resulted in a distribution to a beneficiary that is too large, the court shall restore the beneficiaries, the trust, or both, in whole or in part, to their *appropriate positions* by requiring the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or requiring that beneficiary to return some or all of the distribution to the trust.

3. To the extent that the court *is unable*, after applying subparagraphs (1) and (2), to restore the beneficiaries, the trust, or both, *to the positions they would have occupied if the fiduciary had not abused his, her or its discretion, and if the court finds that the fiduciary was dishonest or arbitrary and capricious in the exercise of his, her or its discretion*, the court may require the fiduciary *to pay an appropriate amount* from his, her or its own funds to one or more of the beneficiaries or the trust or both.

(D) Petition by Fiduciary

Court may, in its discretion, entertain a petition by the fiduciary for a determination as to whether a proposed exercise or non-exercise is an abuse of discretion. Any beneficiary who challenges the action, has the burden of proof providing the disclosure in the petition satisfies the statute. (*UPAIA provided that court shall determine, which requires the court to rule on the question of abuse before the action is undertaken. The substitution of "may" in New York enables the court to decline the anticipatory relief*).

Nothing in the statute is stopping a fiduciary from securing consent from the interested parties.

Reviewing Your Trusts

Trustees, particularly corporate trustees with large numbers of trust accounts, will have to evaluate the conditions of the trust relationship to determine if each trust is a candidate for the exercise of the power, or for the exercise of the election to opt into a unitrust regime.

Revocable trusts, and trusts wholly discretionary as to principal and income, don't need the help of the new act, and are not candidates for the exercise of the power. Trusts that determine what amount may or must be distributed by referring to trust income, i.e., simple trusts and trusts that allow the trustee to sprin-

kle or accumulate income are within the universe of trusts that must be tested.

Those are the trusts concerning which the trustee must reaffirm or reevaluate asset allocations and do so in the context of the terms of the trust, i.e., making sure the trust instrument has not expressly provided contrary directions as to investments or administrative restrictions. Multi-state trusts must be carefully analyzed so that the trustee is satisfied as to which state law should apply. As we have seen, the Principal and Income Acts of the several states, unlike the Prudent Investor Act, vary widely.

Trustees must make these decisions in concert with their continuing responsibility to cooperate with their co-trustees and to be aware of the income beneficiary's circumstances. They are well-advised to make the income beneficiary aware of these new tools if trust accounting income is not fulfilling the needs of the beneficiary.

Unitrust Option

The unitrust provisions are found in EPTL 11-2.4.

The 4% unitrust payout is calculated upon the net fair market value of the trust on the first day of each calendar year. Short years such as the first and last year of the trust are pro-rated, and the amount is prorated with respect to any distribution mandated by the trust. Distributions mandated by the trust are payments of principal to beneficiaries directed by the document, and do not include administration expenses or discretionary invasions of principal. It shall also be pro-rated for additions to corpus.

Commencing the fourth year of the trust, the unitrust amount for the current year shall be four percent multiplied by a fraction the numerator of which shall be the sum of the net fair market value of the current year and the two preceding years, and the denominator shall be three. The three-year calculation is repeated each succeeding year in order to insure that annual payouts are steadier in the face of volatile markets. This is called a "smoothing rule." For the purpose of applying the smoothing rule, additions or reductions in prior years shall be deemed to have occurred on the first business day of the applicable year.

While the assets of the trust must be valued annually, the statute permits the trustee to make a reasonable determination of the value of non-publicly traded assets, and if made reasonably and in good faith, the value is presumed to be conclusive. In fact, if no interested party objects in a court proceeding within three years, they're barred from challenging the value in the future.

Residential real estate and tangible personal property, the use of which is enjoyed by the current beneficiary, is not included in the calculation since the use of the property is deemed to be equivalent to the payout with respect to those assets. Such use is deemed to have occurred as of the first business day of the year, unless such an asset was added to the trust during the year in which case the unitrust amount will be prorated. With respect to assets specifically allocated to the beneficiary, e.g., a particular stock, the dividends generated by this stock and specifically set aside for the beneficiary, is deemed to satisfy the payout with respect to this asset.

The unitrust does not apply to split-interest charitable trusts. However, it does apply to wholly charitable trusts.

Trustees of pre-existing trusts have until December 31, 2005, to elect the unitrust regime.

Trustees of trusts created after the effective date of the act, i.e., January 1, 2002, have two years from the date assets first become subject to the trust to elect the unitrust regime. Assets first become subject to the trust as provided in the governing instrument or in default of that when assets are transferred to the trust. In the case of a testamentary trust, assets are first transferred to the trust when they are in fact distributed by the executor into the trust account. (The unitrust does not apply to estates).

With respect to will substitutes, insurance trusts and third-party irrevocable trusts resulting from an individual's death, the date of death is deemed the date when assets are transferred to the trust.

The election itself can specify the date when the unitrust regime becomes effective, or if pursuant to a court order, the date specified by the court. If no date is specified, the unitrust regime becomes effective the first day of the first year of the trust commencing after the election (or court decision) is made. Incidentally, the trustee has another crack at the election each time all current income interests end, and are followed by a succeeding income interest or interests.

The process of opting into the unitrust regime is accomplished either with the consent of all the beneficiaries to whom process would issue on an accounting proceeding (providing that both virtual and collateral representation apply) or in the discretion of the trustee.

The trustee must serve notice of the election upon the grantor if living; upon all of the aforementioned beneficiaries *or their representatives*; and upon the court, if any, having jurisdiction over the trust. If the trust is

testamentary, naturally the trust will have a file number and some surrogate's court in the state will have jurisdiction. If the trust is *inter vivos*, no notice to the court should be necessary unless there is a current file for an accounting or construction proceeding, or there is an open file for any litigated matter.

After the four-year period for pre-existing trusts, or the two-year period for new trusts has expired, no opt in or out is possible without court approval. A court proceeding to accomplish this can be commenced by either the trustee or any beneficiary on notice to the interested parties. The standard applicable to the consideration of the decision to opt in or out has been taken from the Uniform Act (as it applies to the power to adjust) and requires the court to consider the nature, purpose and expected duration of the trust; the intent of the creator of the trust; the identity and circumstances of the beneficiaries; the needs for liquidity, regularity of payment and preservation and appreciation of capital; as well as consideration of the nature of the assets.

With respect to any such proceeding, there is a rebuttable presumption that the unitrust regime will apply.

Article 11-A Uniform Principal and Income Act

(That is, some highlights besides power to adjust and unitrust).

New Act Divided Into Six Parts

1. Definitions and Fiduciary Duties
2. Decedents Estate or Terminating Income Interest
3. Apportionment at Beginning and End of Income Interest
4. Allocation of *Receipts* During Administration of Trusts
5. Allocation of *Disbursements* During Administration of Trust
6. Miscellaneous Provisions

Part 1—Definitions and Fiduciary Duties

11-A-1.2 Definition. Thirteen definitions appear, appropriately, in the beginning of the Act instead of the four definitions listed in EPTL 11-2.1(o) at the end of the prior law (which, incidentally, still governs all transactions which occurred prior to enactment of the new law).

The two definitions of note are "fiduciary" and "trustee." Fiduciary, of course, embraces both an executor and trustee, while trustee in the Act is meant to refer only to a trustee. In the Uniform Act, therefore, the power to adjust apparently applies to a trustee only. In moving the power to adjust to EPTL 11-2.3 (the Prudent Investor Act), where the definition of trustee includes an executor, the result is that the power to adjust in New York appears to apply to estates as well as trusts. However, when the judicial control of abuse of discretion was added to the Uniform Act, the term used is "Fiduciary," making one believe that the power to adjust might apply to executors in the Uniform Act after all.

Part 2—Decedent's Estate or Terminating Income Interest

11-A-2.1 Determination and Distribution of Net Income (*and expenses*)

This section addresses some of the issues dealt with in the prior law and found in 11-2.1(d) "Income earned during administration of a decedent's estate." It makes those principles applicable to the termination of an income interest in an *inter vivos* trust, as well as a decedent's estate, and this includes under section 11-A-2.1(3) the payment of statutory interest on pecuniary dispositions not in trust, as provided for in EPTL 11-1.5(d).

After allowance is made for pecuniary bequests, this section directs us to carve up income (and principal for that matter) *among* remainder beneficiaries in accordance with the next section, i.e., 11-A-2.2.

While it continues the principle that debts incurred by the decedent should be paid from principal, the trustee has discretion with respect to the allocation of administration expenses.

11-A-2.2 Distribution to Residuary and Remainder Beneficiaries

This section provides for the allocation of income *among residuary beneficiaries* and beneficiaries of pecuniary amounts in trust in much the same way as section 11-2.1(d) of the prior law does, except that in the prior law the allocations for distributions before estate tax is paid are based upon inventory values and allocations for distributions after estate tax is paid is based upon market values immediately before the distribution date. Since the Act bases all allocations upon market value at time of distribution, it's probably fairer, but may also place a greater burden on fiduciaries in terms of valuing assets, particularly non-publicly traded assets.

(Includes gains and losses, too, which is a clarification or codification of existing law).

Part 3—Apportionment at Beginning and End of Income Interest

11-A-3.1 When Right to Income Begins and Ends

When do you have a trust, or when does a successive income interest begin?

This section restates section 11-2.1(c)(1) of the prior law, but with more clarity. It specifically provides that an income interest becomes subject to a trust, if not expressly provided for in the governing instrument, when the asset is transferred to the trust during the transferor's life. (Doesn't define transfer, but EPTL 7-1.18 does).

Here (and in 11-A-3.2 as well) an income interest ends the date **BEFORE** an income beneficiary (or decedent) dies.

11-A-3.2 Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins

This section addresses subjects dealt within sections 11-2.1(c)(2) and (3) of the prior law.

The prior law apportioned income between principal of the testator's estate and the succeeding income interests, but no such apportionment occurred in the transfer of interests by the grantor of an *inter vivos* trust.

The new Act allocates for both estates and *inter vivos* trusts in the same way. Income receipts that are due before date of death or when an asset becomes subject to a trust are to be credited to principal. Therefore, a dividend, which is a periodic payment, that is "of record" (and consequently "due") before death goes to principal and is not apportioned, and the periodic interest payment on a bond that occurs on or after death (or when the asset becomes subject to the trust) is not "due" on death, is not apportioned or accrued, and is payable to the succeeding income interest. The same goes for rent, annuities and mortgage interest.

Income obligations for which there are no "periodic due date" are to be accrued on a daily basis.

11-A-3.3 Apportionment When Income Interest Ends

This changes the rule in the prior law, section 11-2.1(c)4, so that the deceased income beneficiary's estate is entitled to income collected by the trustee but undistributed at the time of death, and not entitled to any accruals of income.

The principle behind this change is that the grantor would have favored the income beneficiary first, the remainder beneficiary second and the income beneficiary's estate last.

Caveat: for portion of principal over which income beneficiary has power to revoke, undistributed income must go to principal. See section 11-A-3.3B.

Part 4—Allocation of Receipts During Administration of Trust

11-A-4.1 Character of Receipts

Corresponds to prior law section 11-2.1(e) "Distributions of corporations or associations"

Embraces corporations, partnerships, limited liability companies, regulated investment companies, real estate investment trusts, common trust funds and other organizations.

Stock or "in-kind" distributions are allocated to principal, however small they are.

Money is income, except:

(a) Money received in exchange for part or all of trust's interest in the entity.

(b) Money received in total or partial liquidation of the entity. [Prior law: section 11-2.1e(6)]

(c) Money received from a regulated investment company or REIT if distributed as a capital gain dividend for federal income tax purposes. (net long-term capital gains) [Prior law section 11-2.1e(7)]

Money is received in partial liquidation if the distributing entity says it is, or total cash and property in distribution (or series of related distributions) is greater than 20% of the entity's gross assets as shown on its year-end financial statements immediately preceding the initial receipt. (whether the entity calls it a partial liquidation or not).

11-A-4.3 Business or Other Activities Conducted by Trustee (Prior law reference: section 11-2.1(g) *GAAP for a comparable business, net profits are income*)

This section now allows a trustee conducting a business activity in proprietorship form, greater flexibility in applying net receipts toward working capital or the acquisition or replacement of fixed assets and other reasonably foreseeable needs of the business, providing the trustee believes that accounting separately for the activity is in the best interests of all the beneficiaries.

11-A-4.8 Insubstantial Allocations Not Required

This applies to the allocation of receipts applicable to

- 4.9 deferred compensation
- 4.10 liquidating assets
- 4.11 mineral interests
- 4.12 timber
- 4.15 asset-backed securities

This paragraph provides that if the allocation of receipts from such assets is insubstantial, then the trustee *may* allocate the entire amount to principal.

An allocation is presumed insubstantial if it increases or decreases income during the accounting period by less than 10%, or the value of the asset producing the receipt is less than 10% of the value of trust assets at the beginning of the accounting period. (*Clearly this is meant to apply to small amounts*).

There is no corresponding provision in the prior law, except insofar as one would apply section 11-2.1(a)1(C) (reasonable and equitable) to such receipts.

11-A-4.9 Deferred Compensation, Annuities and Similar Payments

These include payments over a period of years or the lifetime of an individual for services rendered, or payments from an annuity contract purchased or an IRA. It does not include patents, copyrights and royalties, which are treated separately under section 11-A-4.10. To the extent the payment is characterized (presumably by the payor) as interest or a dividend, it is credited to income. The balance is credited to principal. If no part is characterized as interest or a dividend, and all or part of the payment is required to be made, then 10% is credited to income and the balance to principal. If no part of the payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the entire payment should be credited to principal. Section 11-A-4.9(d) provides a direction to credit sufficient amounts to income to the extent necessary to protect the marital deduction.

The prior law mentioned rights to receive deferred compensation payments along with patents, copyrights and royalties in EPTL 11-2.1(j) and provides that they shall be allocated in accordance with section 11-2.1(a)1(C) (reasonable and equitable).

The deferred compensation allocation rules in the Act are the first clear example of the 90/10 rule. The rationale for plowing 90% of an otherwise unspecified distribution from a depleting asset back into principal is that, when in doubt, it's best to add the receipt to principal. In this way, the principal of the trust has been strengthened for the day when the asset finally self-exhausts, and will continue to earn income for the then current beneficiary. The downside of this rule is that it may not at all reflect the grantor's intent as to how a distribution would be shared by principal and income. Over a long payout period, the income beneficiary receives a disproportionately small percentage of the periodic distribution, and a large amount of ordinary income (since the entire distribution may be ordinary income) can be inadvertently trapped in the trust.

Here is a vivid example where counsel may wish to draft around the statute, or a trustee may wish to exercise the power to adjust.

11-A-4.10 Liquidating Asset

This section applies to leaseholds, patents, copyrights and royalties, and states that 10% of receipts in an accounting period are allocated to income and the balance are allocated to principal.

The prior law applies the reasonable and equitable standard in section 11-2.1(a)1(C).

11-A-4.11 Minerals, Water and Other Natural Resources

The same rules apply to mineral interests, except that the trustee has the option to continue to use the old rules with respect to mineral interests acquired before enactment of the law, and that is because a mineral interest may be interpreted as an interest in real estate and as such may be governed by the law of the *situs* of the interest. The laws of certain jurisdictions, like Oklahoma, may conflict with the new rules.

In the prior law, after specifying particular rules concerning production payments, receipts are generally allocated to income after crediting to principal an amount equivalent to the deduction permitted by the IRS for depletion allowance (currently 15% for gas and oil).

Once again, the rationale for crediting so much to principal under the Act, is that as wells are depleted, the amount received by the income beneficiary may fall drastically. Allocating a larger portion of receipts to principal enables the trustee to acquire other income-producing assets that will continue to produce income when the mineral reserves are exhausted.

11-A-4.13 Property Not Productive of Income

The underproductive property section of the prior law [EPTL 11-2.1(k], which entitled the income benefi-

ciary to receive a portion of the proceeds from sale of a particular asset deemed to be underproductive, is eliminated as in conflict with prudent investor. Instead, this section of the new Act simply provides that if the current return from the trust is insufficient to provide the spouse the beneficial enjoyment necessary to obtain the marital deduction, the spouse may require the trustee to make property productive of income, or to exercise the power to adjust.

11-A-4.14 Derivatives and Options (NEW)

The term "derivative" is very broadly defined as a contract or financial obligation which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets or changes in a rate, an index of prices or rates, or other market indicators for an asset or a group of assets.

To the extent not accounted for separately, the receipts derived from the sale, or the costs incurred by the purchase thereof, are principal.

This section also includes options to buy property from the trust, or sell property to the trust, e.g., puts, calls and options on real estate. These are also credited to principal.

Part 5—Allocation of Disbursements During Administration of Trust

11-A-5.1 Disbursements from Income and 11-A-5.2 Disbursements from Principal, are not dissimilar to prior law [EPTL 11-2.1(1)] except that there is language to clarify the allocation of insurance premiums; and environmental assessment, remediation, removal and reclamation costs, which are charged to principal.

Here, the Act restates that "estate taxes" are paid from principal. It was stated before in section 11-A-2.1 (EPTL 11-2.1(d)(1) says it only once.) However, the second time adds "other transfer taxes," which would embrace GST taxes.

11-A-5.3 Transfers from Income to Principal for Depreciation

Prior law has no such section. The Act specifically gives the trustee a discretionary power of administration to transfer a reasonable amount of income (generally derived from rents) to principal in order to:

(1) help make principal payments on a mortgage on depreciable property [see also section 11-A-5.4(b)4]; or

(2) to compensate remainder beneficiaries for capital gains tax paid on the ultimate sale of fully depreciated property; since the income beneficiary has reaped the benefit of depreciation deductions through the years.

The power is discretionary since the value of the real estate may appreciate so much as to render such an adjustment wholly unnecessary.

11-A-5.6 Adjustments Between Principal and Income Because of Taxes

This section allows the trustee to make adjustments between principal and income that the trustee deems reasonable to achieve an equitable result, when, for instance, tax has been paid by one party and someone else reaps the benefit, or economic interests are shifted because of tax elections. For example, if an executor makes a non-pro rata in-kind distribution on account of residue to one of the beneficiaries but does not make a distribution of income, in that taxable year, distributable net income (DNI) to the extent that the principal distribution equals or exceeds it, will be taxed out to that one beneficiary. When income is finally paid to all the beneficiaries, the other beneficiaries will receive their share of DNI for that prior year tax-free. Section 11-A-5.6(2) enables the fiduciary to make an equitable adjustment between the parties.

Also, commentary to the Act provides another example.

> Section 11-A-5.6(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. (*the income beneficiary is treated as a "substantial owner" for the purposes of the income of the Sub Chapter S Corporation)*. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

Conclusion

The New York Principal and Income Act contains strategic changes in the allocation of receipts and disbursements in following the rule of Article 11-A, but the real change is the empowerment of a trustee through the equitable adjustment and the unitrust to invest the trust assets pursuant to risk and return objectives suitable for the entire portfolio, without worrying about which side of the ledger to credit a particular receipt.

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2001 New York State Legislative Session Changes Affecting Estate Planning and Administration

By Joshua S. Rubenstein

The 2001 legislative session brought numerous substantive changes to the laws affecting estate planning and administration. There were many accounting-related changes, designed primarily to modernize concepts of, and allocations between, income and principal. There were a number of important procedural changes as well.[1] The following is a review of each such change.

Surrogate's Court Procedure Act

Probate Proceedings

1. Surrogate's Court Procedure Act 1411(3) (SCPA) has been amended to provide that whenever objections are filed to the probate of a will, the additional citation need not be issued to each person named or referred to in the propounded instrument who has not appeared in the proceeding, unless his or her interest would be affected by the outcome of the proceeding. This change is effective immediately.[2]

Claims

2. SCPA 1813(1) has been amended to permit an application for the compromise or sale of any estate claim to be brought by any person (other than a claimant), whose rights or interests will be affected by the allowance of the claim, not just by the fiduciary. This change is effective immediately.[3]

Accounting

3. A new section 2222-a has been added to the SCPA, providing that whenever a legatee, distributee or beneficiary is an inmate or prisoner in a state or local correctional facility, the court shall give prompt written notice to the State Crime Victims Board and direct that no payment be made to such inmate or prisoner for a period of 30 days following the entry of the order containing such direction. This change is effective immediately, and it applies to all judgments originally entered prior to the effective date, as well as to all judgments, obligations or agreements to pay profits from a crime or funds from a convicted person entered, incurred or entered into, on or after the effective date.[4]

Costs, Allowances and Commissions

4. A new section 2308(1)(c) has been added to the SCPA, providing that in the case of trusts created on or before August 31, 1956:

   (a) receiving commissions shall not be allowed to a trustee who qualifies on or after June 5, 1978, and shall not be allowed on additions of property received on or after such date;

   (b) such commissions on any increments in property that are payable by reason of any sale, exchange or liquidation of such property, shall be allowed on the lesser of (1) the amount of such increments on the date of such sale, exchange or liquidation and (2) the amount of such increments on June 5, 1978; and

   (c) such commissions on any increments in property that are payable by reason of any distribution of such property shall be allowed on the lesser of (1) the amount of such increments on the date of distribution and (2) the amount of such increments on November 1, 2001, the effective date of this change (the first date of the month next succeeding the date of enactment).[5]

5. SCPA 2308(3) has been amended to provide that in the case of trusts whose income is governed by a unitrust election, annual commissions shall be payable from corpus and not out of the unitrust amount. This change is effective on January 1, 2002.[6]

6. SCPA 2309(3) has been amended to provide that in the case of trusts whose income is governed by a unitrust election, annual commissions shall be payable from corpus and not out of the unitrust amount. This change is effective on January 1, 2002.[7]

7. SCPA 2312(5) has been amended to provide that in the case of trusts whose income is governed by a unitrust election, annual commissions shall be payable from corpus and not out of the unitrust amount. This change is effective on January 1, 2002.[8]

Estates, Powers and Trusts Law

Trusts

8. A new section 7-1.13(k) has been added to the Estates, Powers and Trusts Law (EPTL), permitting division of trusts for the purpose of having one or more trusts governed by the Uniform Principal and Income Act and another one or more trusts governed by a unitrust election. This change is effective on January 1, 2002.[9]

Powers

9. EPTL 10-6.6 has been amended, and a new paragraph (g) has been added, to provide that a trustee with an absolute power of invasion over principal may exercise such discretion by appointing principal in further trust with or without the consent of persons interested in the trust, and with or without prior court approval, and to provide that this section does not abridge any comparable power such a trustee has under any other statute or under common law. This change is effective immediately.[10]

Fiduciaries

10. EPTL 11-2.1(m) has been amended to provide that the existing Principal and Income Act shall not apply to any receipt or expense received or incurred by any trust or decedent's estate after January 1, 2002, the effective date of this change.[11]

11. EPTL 11-2.3(b) has been amended by renumbering subparagraph 5 as subparagraph 6 and by adding a new subparagraph 5 to the Prudent Investor Act, providing for a power to adjust between principal and income to the extent that a trustee considers it advisable to do so in order to enable the trustee to make appropriate present and future distributions, and setting forth those factors to consider in exercising such power. This change is effective on January 1, 2002.[12]

12. A new section 11-2.3-A has been added to the EPTL, providing for judicial control over the power to adjust between income and principal, providing that a court may not change the fiduciary's decision, unless it determines that the fiduciary's decision was an abuse of discretion, and setting forth the available remedies in the event that an abuse of discretion is found. This change is effective on January 1, 2002.[13]

13. A new section 11-2.4 has been added to the EPTL, providing for an optional unitrust provision, whereby the net income of any trust to which this section applies will mean a unitrust amount equal to 4 percent of the fair market value of the assets held in the trust on the first business day in the current valuation year, or, if the trust has been in existence for four or more years, 4 percent of the average such fair market value for the current year and the prior two years. This section will apply (i) if the governing instrument so provides; (ii) if, with respect to a trust in existence prior to January 1, 2002, the trustee, with consent on behalf of all persons interested in the trust or in the trustee's discretion, elects to have this section apply on or before December 31, 2005; or (iii) if, with respect to a trust not in existence before January 1, 2002, the trustee so elects on or before the last day of the second full year of the trust, beginning after assets first become subject to the trust. This change is effective on January 1, 2002.[14]

Other Provisions

14. Section 13-2.2(a) of the EPTL has been amended to reflect references to newly enacted provisions of Article 9 of the Uniform Commercial Code with respect to transfers and mortgages of interests in decedents' estates, and the requirements of writing and recording thereof. This change is effective on July 1, 2001.[15]

Uniform Principal and Income Act

15. A new Article 11-A has been added to the SCPA, incorporating the new Uniform Principal and Income Act with certain modifications. Part 1 sets forth definitions and fiduciary duties. Part 2 provides for the determination and distribution of net income (from estates and terminating income interests). Part 3 provides for the apportionment of the beginning and end of an income interest. Part 4 provides for the allocation of receipts during the administration of a trust, setting forth specifically the treatment of receipts from entities, receipts not normally apportioned, and receipts normally apportioned. Part 5 provides for the allocation of disbursements during the administration of a trust. Part 6 provides for certain miscellaneous rules governing the application and construction of the Act. This change is effective as of January 1, 2002.[16]

Insurance Law

Rules

16. Insurance Law § 1110(b) and (c) have been amended with respect to investment limitations for charitable gift annuity societies, to permit such investments to be made in accordance with prudent investor standards. This change is effective immediately.[17]

Endnotes

1. A bill that passed the Assembly on February 26, 2001, and the Senate on March 20, 2001, would have added a new section 4501-a to the Civil Practice Law and Rules, providing for the uniform treatment of professional privileges upon death or disability. The bill provided that the personal representative succeeds to all the communicant's rights and privileges with respect to the privilege after the communicant's death or during the communicant's disability, and the privilege may be waived by any party in interest in any action or proceeding with respect to the validity or construction of any gratuitous transfer of property. Medical professionals may not withhold information as to the mental or physical condition of a communicant from a surviving spouse or distributee, but no professional in possession of any information that would tend to disgrace the memory or reputation of a decedent or disabled communicant shall disclose such information except upon order from the court. The bill would also have amended Civil Practice Law and Rules § 4503 by deleting paragraph (b), which provided for the probate exception to the attorney-client privilege, which is now contained in new section 4501-a. These changes would have been effective 60 days after enactment. The Governor belatedly vetoed this bill on November 13, 2001.
2. Chapter 393 of the Laws of 2001, S.2936, A.8357, signed October 31, 2001.
3. Chapter 234 of the Laws of 2001, S.5514, A.7345, signed September 4, 2001.
4. Chapter 62 of the Laws of 2001, S.5110, A.9278, signed June 25, 2001.
5. Chapter 376 of the Laws of 2001, S.795A, A.7792, signed October 23, 2001.
6. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
7. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
8. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
9. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
10. Chapter 204 of the Laws of 2001, S.3751A, A.7699A, signed August 20, 2001.
11. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
12. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
13. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
14. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
15. Chapter 84 of the Laws of 2001, S.5404A, A.8959A, signed June 29, 2001.
16. Chapter 243 of the Laws of 2001, S.5531A, A.9050B, signed September 4, 2001.
17. Chapter 419 of the Laws of 2001, S.3770, A.9118, signed October 31, 2001.

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Further Centralization for Internal Revenue Service—Powers of Attorney

Taxpayers can appoint individuals as representatives to receive confidential tax information. These forms include a Power of Attorney (Form 2848) and Tax Information Authorization (Form 8821). In continuing its consolidation, starting January 1, 2002, practitioners need to request third-party authorizations through two service centers. The only exception to this will be international requests, which will be processed in the Philadelphia office.

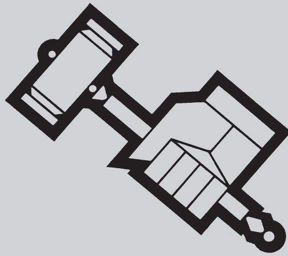
The IRS expects the benefits for this to be:

- Provision of consistent customer service and a focal point for customer inquiries;
- Simplification of procedures for obtaining authorization;
- Improvement of timeliness and accuracy;
- Assistance in reduction of unauthorized disclosures; and
- Provision of easier access to third-party information.

The two centers which practitioners will be required to use are:

- Memphis IRS Center, P.O. Box 30309 Stop 8324, Memphis, Tennessee 37501, telephone number: (901) 546-4176, fax number: (901) 546-4115; or
- Ogden IRS Center, P.O. Box 9941 Stop, Ogden, Utah 84409, telephone number: (801) 620-4254, fax number: (801) 620-4249.

The IRS advises that it processes faxed requests within 48 hours, and paper requests within five days at the present time.



RECENT NEW YORK STATE DECISIONS

John C. Welsh

WILLS

CONSTRUCTION—APPLICATION OF *PER STIRPES*

Testator's will placed his residuary estate in trust to pay or apply the income and/or principal to his daughter, E, and her issue or any of them as the trustees in their absolute discretion shall see fit. Upon the death of E, the balance in the fund was to be distributed to the issue of E and of his sons, J and R, *per stirpes*, with one exclusion. At the death of testator, both sons were childless and E was the mother of seven children. Thereafter J adopted a daughter, who claimed one-half of the estate upon E's death. The six eligible children of E claimed that the adopted daughter should be limited to a one-seventh share, an amount equal to that allotted to each of them. The Appellate Division agreed with the Surrogate that *per stirpes* described the testator's method of distribution for the issue of his children, not for his children. The estate was divided into seven equal parts. *In re Magnor*, ___ A.D.2d ___, 729 N.Y.S.2d 771 (2d Dep't 2001).

UNDUE INFLUENCE—CONDITIONAL GIFT

About five weeks before testator's death, he sought preparation of a will which divided his entire estate equally among his sister, her two daughters and a neighbor. Eight days later, testator told the drafter that he wanted to substitute the ex-husband of his sister for his neighbor. The new will was drafted and executed. About three weeks later, the sister presented to the testator, who was now hospitalized, a proposed codicil reciting that testator was unaware of the divorce when he included the ex-husband as a residuary beneficiary. It excluded the ex-husband and divided the entire estate among the three remaining beneficiaries. The sister made two efforts to obtain execution of the codicil but was thwarted by an approaching hurricane and by testator's serious illness. Upon testator's death, the sister unsuccessfully sought to have her ex-husband deleted as a beneficiary under the will on the grounds of fraud and undue influence. The ex-husband and his new wife had visited testator six times in eight days prior to the will execution. Minimal contact had existed between them in the years immediately prior. Mere opportunity to influence and motive were insufficient to void the gift. An argument that the gift to the ex-husband was conditional upon him being married to testator's sister also failed. Conditional gifts are not favored in the law and will not be found to exist without clear language indicating that intention. *In re Estate of D'Agostino*, ___ A.D.2d ___, 728 N.Y.S.2d 234 (3d Dep't 2001).

OBJECTANT'S RIGHT TO A CONTINUANCE

Decedent's will left her entire estate to her two daughters; A received $50,000 and B was given the residuary. After a jury trial on A's objections based on lack of testamentary capacity and undue influence, the will was admitted to probate. At the end of the testimony, objectant sought and was denied a continuance to introduce additional proof to support the allegation of lack of capacity. The Appellate Division found that the Surrogate's refusal to grant the delay was an abuse of discretion. The testimony of the witness appeared to be material and he would have been available on the following day. *In re Estate of Shepard*, ___ A.D.2d ___, 728 N.Y.S.2d 784 (2d Dep't 2001).

MISTAKE OF TESTATOR

Decedent's will executed ten years before his death, left his residuary estate, consisting solely of his residence to his daughter, L. On the day the will was executed, he also signed an affidavit stating that this disposition was made because L was the only one of his four children who did not own her own home. The three excluded children opposed probate on the ground that decedent was under a mistake of fact because two of them were not homeowners. The gift to L in the will was set forth clearly and without any statement of motivation. The court dismissed the objections and declined to reform the will. *In re Estate of Patrick*, 188 Misc. 2d 295, 728 N.Y.S.2d 354 (Sur. Ct., Onondaga Co. 2001).

ADMINISTRATION OF ESTATES

CONFIDENTIALITY AGREEMENT

In an accounting proceeding brought by the committee of decedent's person and the co-committees of decedent's property, movants sought attorneys' fees that were opposed by decedent's executors. In a settlement agreement, the executors retained the right to challenge the fees claimed in Surrogate's Court. The confidentiality contemplated by the settlement was necessarily dependent upon the discretion of the Surrogate. The Appellate Division upheld the Surrogate's denial of the committees' request to seal the executor's objections. In order to warrant confidentiality, the court must make an independent finding of good cause shown. There is a legitimate public concern in judicial proceedings where questions exist as to propriety of the acts of the fiduciaries or their attorneys. Embarrassing allegations, even if unfounded, are an insufficient basis to seal the records. *In re Will of Hofmann*, ___ A.D.2d ___, 727 N.Y.S.2d 84 (1st Dep't 2001).

ACCOUNTING—BURDEN OF PROOF

Upon the death of a law partner, the partnership agreement provided that the deceased partner's net equity interest be calculated by the law firm's regular accountant. It appeared that the valuation furnished was complete and accurate. As such, it satisfied the burden of the accounting party. Under the agreement, an objectant was required to show gross negligence or willful misconduct in any challenge to the evaluation. The Surrogate correctly held that proceeds of life insurance policies provided by the firm were intended to be used to buy out the interest of the deceased partners. Other members of the firm were competent to testify to that effect. *In re Tracht*, ___ A.D.2d ___, 727 N.Y.S.2d 148 (2d Dep't 2001).

ACCOUNTING

Although the designated executor received prompt notice of her designation, she failed to probate decedent's will until 18 months after his death. Under the will, objectant was devised certain real property but the devise was subject to the express direction that the executor was to sell the premises if the other assets were insufficient to pay all estate obligations. During the period of delay prior to probate, the property was vandalized. The Appellate Division agreed that the executor was not entitled to dismissal of objections to her account filed by the devisee. Issues of fact existed as to whether she had failed to assess the assets of the estate and neglected to preserve the estate prior to probate. *In re Estate of Skelly*, ___ A.D.2d ___, 725 N.Y.S.2d 666 (2d Dep't 2001).

LEGAL FEES—DISCRETION OF SURROGATE

Upon the death of testator, the designated executor retained the attorney in possession of the will to settle the estate. No discussion of fees occurred at that time. The attorney prepared the relevant documents for an uncontested probate and met with distributees to obtain waivers. Several days later, the executor inquired of the attorney as to the amount of his fee and was told that it would be a percentage of the estate. The executor promptly engaged another attorney. Upon notification that he had been replaced, the attorney refused to turn over the documents unless a fee of $2,000 was paid. He then filed the probate petition, identifying himself as attorney for the estate. Thereafter, the attorney began a proceeding under SCPA 2110 to fix his fee at $5,000. The Surrogate, after a full day of testimony, fixed the fee at $450. The Appellate Division found that no abuse of discretion had occurred. *In re Estate of Klein*, ___ A.D.2d ___, 726 N.Y.S.2d 814 (3d Dep't 2001).

SMALL ESTATE ASSETS

Decedent's assets, which totaled less than $20,000, included a purchase money mortgage on real property securing a debt with a reduced balance of $1,862. Although the use of SCPA Article 13 relating to small estates is restricted to personal property, it continued to be available to this estate since debts secured by mortgages are personal property. The recordable nature of the mortgage is irrelevant. By statute, discharges of mortgages may be executed by voluntary administrators, thus implying that a real property mortgage may become part of a small estate when total estate assets do not exceed the upper limit. *In re Estate of Scheuer*, 187 Misc. 2d 941, 725 N.Y.S.2d 188 (Sur. Ct., Greene Co. 2001).

TRUSTS

REVOCATION

In 1978, settlor created a revocable trust to pay income to herself for life with principal to be distributed upon her death. Six years later, settlor executed an "Amended and Restated Trust Agreement" that modified some terms in the original trust and preserved the others. In 1990, settlor executed a third trust instrument which described the 1978 trust as "amended and restated" in 1984 with an intent "to further amend and restate" the 1978 trust agreement. Six months later, settlor notified the attorney-drafter that she had revoked the trust because she was not happy with it. After settlor's death, the executor of her will successfully claimed that all assets formerly held by the trusts were assets of the estate since no

vestige of any trust remained. A substantial beneficiary of the 1984 disposition had claimed that a portion of that trust continued to exist. The Appellate Division found that each new agreement was intended to supersede the prior plan. Retention of assets in the names of the trustees designated in 1984 and failure to deliver assets to the new trustee named in 1990 did not show a desire to retain any part of the 1984 plan. No questions of fact existed. *In re Estate of Kneznek*, ___ A.D.2d ___, 727 N.Y.S.2d 180 (3d Dep't 2001).

CLAIMS OF TRUST BENEFICIARY

Plaintiff's grandfather died in 1966 leaving a will which created a residuary trust for the benefit of his son and daughter and their living children. The two children terminated the trust in 1972, claiming that the will gave them that authority. When the daughter died in 1989, her estate included some of the distributed assets and these items were reported in the estate tax return filed for her estate. When plaintiff claimed a share of the residuary trust that had been terminated prior to her adulthood, the personal representative filed a refund claim with the IRS. This claim was disallowed on the ground that plaintiff was unlikely to succeed in recovering any part of the distributed assets. The personal representative, at the request of the IRS, signed a waiver of statutory notice of disallowance of claim and the statute of limitations for a refund demand expired two years later in 1994. Plaintiff discovered in 1996 that the refund claim had been disallowed. In a suit against the personal representative and its attorneys, the cause of action based upon fraud was barred by the statute of limitations because the fraud occurred more than six years before suit and discovery was more than two years prior. The cause of action against the attorneys for malpractice failed because plaintiff was never the client of either defendant. Additionally, both causes of action were barred by the express terms of a settlement agreement. The cause of action for conversion was timely. Since the original possession was not wrongful, the statutory period did not begin to run until a demand and refusal occurred. *D'Amico v. First Union National Bank*, ___ A.D.2d ___, 728 N.Y.S.2d 146 (1st Dep't 2001).

OBJECTIONS TO INVESTMENT POLICY

Objections to the final account of trustees were filed on behalf of the income beneficiary and remainderman. Testimony of objectants expert failed to show that the investment policy was imprudent. The trustee should provide a balanced portfolio and U.S. Treasury bills may be included. The expert failed to consider capital gains taxes and other expenses paid annually from principal. Comparison with two indices that were based on equity values was not appropriate. *In re Gerster*, ___ A.D.2d ___, 726 N.Y.S.2d 90 (1st Dep't 2001).

OBJECTIONS TO FINAL ACCOUNTING

Settlor created an *inter vivos* trust which was funded by his residence, items of tangible personal property and the proceeds of a note and mortgage. The monthly proceeds of the note and mortgage were to be divided between his wife (60 percent) and his children (40 percent). Upon the wife's death, the trust was to end and the balance in the trust was to be distributed to his children. Previous litigation had resulted in a judicial direction to restore improper payments. Since the Surrogate had authorized the trustee to sell the residence and distribute to the widow the value of her interest, there was no reason to continue the trust with the small amount of remaining principal. Consent of the objecting remainderman was not required. Expert testimony offered by the remainderman was precluded when she failed to provide justification within the time set by the court. An issue as to whether the trustee was barred from claiming commissions was not preserved for review. *In re Wible Trust*, ___ A.D.2d ___, 726 N.Y.S.2d 175 (3d Dep't 2001).

CEMETERY ASSOCIATIONS—LEGAL FEES

Testator died in 1957 leaving a will which created a trust to pay the income to two cemetery associations for the perpetual care of family plots in each cemetery. In 1997, the cemeteries filed a joint petition to remove the trustee and invade principal to defray capital improvements and other expenses of the cemeteries. After the Attorney General opposed the relief sought, extensive negotiation resulted in a settlement agreement. When the fee claimed by the attorney for the cemeteries exceeded by $5,000 the amount allowed by the court, the attorney billed the cemeteries for the disallowed amount and ultimately received the original fee agreed upon. No disclosure was made to the court about a claim for additional fees at the time the judicial allowance was made. The settlement agreement had provided that legal fees would be set by the Surrogate. The court had inherent authority to disregard the private fee contract between the attorney and the clients and focus on the settlement agreement which appeared to limit fees to the amount of the future allowance. *In re Estate of Cono*, 188 Misc. 2d 400, 728 N.Y.S.2d 889 (Sur. Ct., Oneida Co. 2001).

CONSTRUCTIVE TRUST—ACCOUNTING

After a three-year relationship as a lesbian couple, M and K separated. While they were together, M opened a checking account and a money market account jointly in the names of M and K. Additionally, M purchased a condominium apartment and a home in the Hamptons in both names. Other assets were held similarly, even though K contributed little or nothing to the acquisition of each asset. M claims that

the joint ownership plan was intended to provide survivorship benefits to K upon M's death, but M would remain the full equitable title holder while both parties were alive. Following the breakup, M executed deeds severing the joint tenancies for both parcels of realty and withdrew substantial sums from joint brokerage accounts. No written document defining property rights was ever executed by either party. M was allowed to submit her proof in support of her claim for reformation of title documents and to impress a constructive trust. Fact questions existed as to whether K had been unjustly enriched. The information K sought by requiring M to account for monetary withdrawals was available to K through discovery. *Minieri v. Knittel*, 188 Misc. 2d 298, 727 N.Y.S.2d 872 (Sup. Ct., N.Y. Co. 2001).

MISCELLANEOUS

OWNERSHIP CHANGE IN IRA

During his last illness, decedent transferred funds from an Individual Retirement Account (IRA) naming his adult children by a previous marriage as partial beneficiaries to an IRA naming his wife as sole beneficiary. In their complaint to recover the funds transferred, the children unsuccessfully alleged undue influence, conversion and intentional infliction of emotional distress. Since the decedent had been married to his current spouse for ten years at the time of the transfer, no inference of undue influence arose. The complaint did not allege acts of undue influence with sufficient specificity to survive a motion to dismiss. The cause of action based on conversion was legally insufficient, since the children had no interest in the account at the time of the withdrawal. Additionally, the alleged conduct by the wife did not rise to the level of being atrocious and utterly intolerable to sustain an emotional distress action. *Thea v. Thea*, ___ A.D.2d ___, 726 N.Y.S.2d 655 (1st Dep't 2001).

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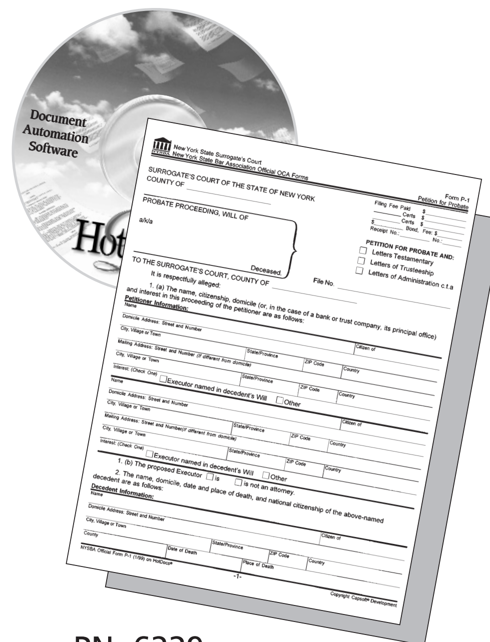

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