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Trusts and Estates Law Section Newsletter

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A Message from the Section Chair

Philip L. Burke

Watching the news reports out of San Diego following the Fall conference reinforces our understanding that life is full of striking contrasts. Seeing the devastation wrought by the wildfires after having spent several days enjoying the sights and sounds of the Hotel del Coronado, Balboa Park, the *USS Midway* and Greater San Diego helps us to put everything into perspective. Needless to say, our thoughts and prayers are with all of those affected by those events.

On a lighter note, by all accounts it appears that the Fall program in San Diego was a great success. Our thanks again go out to Linda Wank and Carl Baker, the Co-Chairs, to Ilene Cooper and Joe La Ferlita, the coursebook editors, and to all the speakers who made the topics so interesting. An event requiring special mention was the tour of the *USS Midway* and the fact that our former Chair, Mike Zuckerman, served aboard the *Midway* "back in the day." It was especially enjoyable to be in the tour group along with Mike and experience his first trip back onboard.

With regard to more substantive matters, I urge you to go to the New York State Bar Association Web site (www.nysba.org) and to the Trusts and Estates Law Section page. There you will find a link to "Pending Legislation" which can bring you up-to-date on the status of various bills, as well as those that have been passed and signed into law by the Governor.

Plans are underway for the Trusts and Estates Law Section Program at the Annual Meeting in New York City, which will be held on January 30, 2008. The Program will focus on non-tax considerations in drafting Wills and Trust documents. Joe Samulski, at the Bank of New York, has graciously agreed to chair this program. Please mark your calendars and more information will be forthcoming.

As this will be my last Message as Section Chair, I would like to thank all of you who have helped to

Inside

Dangers Lurk for Providers of Professional Services to Fiduciaries, Even After They Have Been Paid in Full 3
(Stephen Hochhauser)

The New Frontier: Non-Charitable Estate Planning Transfers with Fractional Interests in Art (and Other Personal Property) 9
(Lance S. Hall, ASA)

Foreign Corporations Owned by U.S. Persons 17
(G. Warren Whitaker)

Have You DRA Proofed Your Power of Attorney? 20
(Anthony J. Enea)

Ties to U.S. and Canada 21
(Michael W. Galligan, Jeffrey B. Kolodny and Rachel E. Small)

Tax Incentives for Land Conservation Easements 24
(Bonnie McGuire Jones)

Recent New York State Decisions 27
(Ira Mark Bloom and William P. LaPiana)

Case Notes—New York State Surrogate's and Supreme Court Decisions 30
(Ilene Sherwyn Cooper)

Scenes from the Fall Section Meeting in San Diego, CA 35

make this a tremendous experience, especially those of you who serve on the Executive Committee and on the substantive committees. Your efforts in improving this area of law for all practitioners are deeply appreciated. All one has to do is look at the new legislation on the Web site to see the results of your efforts. But it is more than that. Your willingness to speak at CLE programs, mentor younger attorneys, attend functions on behalf of the Section and other activities prove to our colleagues and to the public at large that members of this Section are true leaders, not only in the State and local Bar Associations, but in the community as well.

I have also had the opportunity to learn about other non-professional activities that many of you are involved in. Knowing that we all take time away from the office to give back to the community is heartwarming. The charitable endeavors and public good that you involve yourself in are as varied as our membership. One of our members was unable to make the meeting in San Diego because he was accompanying a group from his church on a mission to West Africa. Another was unable to attend due to obligations with elderly parents. I have also learned that many of our members volunteer with local food kitchens, homeless shelters, helping the immigrant population and other causes. We don't see this type of "lawyer activity" on the front page of the paper, although it deserves recognition. To say that I am proud to be associated with this group of people would be a drastic understatement. Keep up the good work!

I hope to see you at the January Meeting.

Philip L. Burke, Chair
Trusts and Estates Law Section

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Dangers Lurk for Providers of Professional Services to Fiduciaries, Even After They Have Been Paid in Full

By Stephen Hochhauser

I. Introduction

If you think you are home free when you receive a check from a fiduciary in full payment of your bill for services to an estate or trust, you are mistaken. There are dangers lurking in the SCPA that practitioners should know about. This is especially true where it has been many years since the services were rendered and payment was received, and the practitioners who performed the services may be dead, retired or otherwise incapable of assisting in the preparation of an affidavit of services.

Unless or until the Surrogate has entered a decree approving the fees, the providers of services face a risk that the fees might not be approved, and that a refund of some or all of the fees may have to be made. Even if the fiduciary and all the beneficiaries do not protest the fee, the Surrogate, *sua sponte*, can examine the matter and rule against the provider.[1]

Modest estates with modest expenditures for professional services are not likely to be bothered either by the Surrogate or by the beneficiaries. But, when a fiduciary accounts for a substantial estate or trust,[2] and lists substantial legal or other professional fees that have been approved and paid, the provider may have to defend the fees whether or not the beneficiaries object.

When a judicial accounting is filed, professional providers of services to the fiduciaries can be required to submit affidavits that justify the fees they received from estates or trusts.[3] The only statutory time limit on judicial accountings is that they may not be rendered less than a year from the date of a decree judicially settling a prior accounting.[4] Guardians appointed under Article 81 of the Mental Hygiene Law must submit annual reports.[5] Final accounts for decedents' estates typically span only a few years from the date of death until the estate is distributed, although in cases where litigation or tax proceedings prolong the administration of the estate, the account may span many years.

However, in the case of trusts which can last as long as permitted under the rule against perpetuities,[6] the costs and expenses of preparing accountings in judicial format militate against rendering frequent judicial accountings. Therefore, voluntary intermediate accountings are not normally filed until the occurrence of an event that warrants an accounting, such as the death or resignation of a trustee, or the death of one of several beneficiaries. Thus, a trustee's account may span several decades.[7]

In view of *Stortecky* (*supra* note 1) and *Lafferty* (*supra* note 1) informal accountings may not serve to protect either fiduciaries or professional providers of services from a subsequent review by the Surrogate of the fairness or reasonableness of their fees. Moreover, since the release provided with informal accountings is only as good as the accounting itself,[8] the release may not serve to protect the fiduciary or the provider if the informal account does not include an affidavit of professional services that provides the beneficiaries with the information they need to evaluate the fees shown as administration expenses.[9]

Where the services were performed many years prior to the accounting proceeding, some or all of the providers' time records and files may have been purged or otherwise lost or destroyed, and there may not be any witnesses with personal knowledge who can explain and justify the services that were rendered. In such a case, if a beneficiary or the Surrogate, *sua sponte*, objects to the fees, and the providers are unable to present adequate evidence to justify what they received, the fiduciary may be in jeopardy of a surcharge, and the service provider may be in jeopardy of a decree directing a refund.[10]

This article will discuss the scope of the Surrogate's right to review and approve professional fees, and, in particular, the problems faced by providers whose services were rendered during an accounting period that spans a decade or more.

II. The Surrogate's Right to Review and Approve Professional Fees

Under SCPA 2110(1) the Surrogates have been given express statutory authority to fix and determine attorneys' fees for services rendered to fiduciaries or other parties interested in the estate, including beneficiaries.[11] SCPA 2110(2) permits the attorney, the fiduciary or an interested party to initiate the proceeding.

There is no special statutory authority permitting the initiation of a proceeding by accountants or other non-attorney providers of services to trusts and estates to fix and determine their fees. Indeed, an attempt by an executor to fix and determine an accountant's fees under SCPA 2110 was dismissed by the Nassau County Surrogate's Court for want of statutory authority.[12]

However, accountants or other providers of professional services who have not been paid can bring an action in Supreme Court or initiate proceedings as

creditors to compel payment of their fees.[13] Otherwise, non-attorney providers of professional services have to wait until an accounting proceeding is filed by the fiduciaries pursuant to Article 22 of the SCPA before they can have their fees reviewed and approved by the Surrogate. In 1994, a New York County Surrogate held that even though a will expressly authorized the engagement of a particular accountant, where the aggregate of the attorneys' and accountants' fees was determined to have been unreasonable, approval of part of the accountant's fee was denied.[14]

Fiduciary accountings can be instituted voluntarily by the fiduciary under SCPA 2210. Fiduciaries can also be compelled to account under SCPA 2205(2) by any one or more of a host of specified individuals, namely: creditors; any interested party; public administrators; a person on behalf of an after-born infant who claims an interest in the estate; the estate of a deceased fiduciary; the surety of a fiduciary required to account; a successor fiduciary or remaining fiduciary after the predecessor fiduciary's letters have revoked; co-fiduciaries who have petitioned for the settlement of their own accounts; or by the Attorney General if any part of the estate may escheat to the state.

Judicial accountings are comprehensive. They set forth all of the estate's or trust's financial transactions, including the payments to all providers of professional services. The petition requests a decree approving all of the acts of the accounting fiduciary, including the fees paid to those providers. If the fiduciary has used estate or trust funds to pay substantial fees to an accountant, the dates of payments and the amounts paid will be listed as administration expenses in the accounting, and the petition and citation seeking court approval of the accounting can and should identify and cite the providers of the services and expressly request that the Surrogate approve those payments. Indeed, some Surrogates will refuse to entertain a fiduciary's petition to settle its account unless the petition and citation name the providers, request that their fees be approved and attach affidavits of services that conform to § 207.45 of the Uniform Rules—Surrogate's Court (22 N.Y.C.R.R. § 207.45).[15]

The fiduciary's failure to cite the service providers will leave the court with no choice other than to surcharge the fiduciary if the fees paid are found to have been unreasonable and excessive.[16]

Thus, unless the estate or trust and the professional fees are relatively small, the attorneys and accountants or their firms who received the fees will be cited and required to file affidavits of services even if many years have elapsed since the services were rendered and payment was made in full. If the service providers no longer have the files and documents that they need in order to support approval of the fees, they are at risk of being directed to refund the fees, and the fiduciary is at risk of being surcharged.[17]

Under SCPA 2110(3), the Surrogate has the express right to direct attorneys to refund amounts paid that are found to be excessive. Article 22 of the SCPA does not contain such express authorizations to direct the refund of unreasonable or excessive accountant or other professional fees. However, under EPTL 11-1.1(b)(22), the fiduciary is authorized to pay only "reasonable and proper expenses of administration," and implicit in the Surrogate's power to approve the fiduciary's account is the right to review those expenditures. Thus, notwithstanding the absence of an express authorization, courts have directed accountants to refund fees that were found to have been excessive or of no value to the estate.[18] Other courts have held that they have broad powers including the power and authority to enter a decree directing refunds to the estate or trust.[19]

The Surrogate's right to review professional services is without regard to the existence of retainer agreements and without regard to the consent of the fiduciaries and beneficiaries.[20] Moreover, there is an implied covenant in all professional agreements with fiduciaries that the fees be reasonable and fair.[21] If the professional fees paid by an estate or trust are found to have been unfair or unreasonable, the Surrogate either compels a refund from the provider or simply surcharges the fiduciary without compelling a refund.[22]

The authority of the Surrogate to disregard retainer agreements is a modification of the general rule that absent fraud, over-reaching or unconscionability, agreements by clients to pay professional fees are enforceable by courts.[23] Thus, if a fiduciary is surcharged for having paid fees that are determined to have been unfair and unreasonable, the fiduciary could seek a refund under a claim of breach of an implied covenant that the fees be fair and reasonable.[24]

III. Special Issues Regarding Payment for Accountants' Services

EPTL 11-1.1(b)(9) and (10) authorize fiduciaries to engage banks or trust companies to serve as custodians for their portfolios of securities. As part of their custodial services, banks and trust companies typically perform routine bookkeeping functions with respect to the securities and cash assets that they hold for the estate or trust, and provide monthly and year-end statements. Thus, there is a high threshold that must be met before accountants' fees can be justified as reasonably necessary.[25] Accountants also have to overcome the general principle adopted in case law that routine tax and financial matters are the responsibility of the fiduciary and the attorneys engaged by the fiduciary.[26]

The engagement of accountants and payments to them will be approved if the services are not routine

and require special accounting skills, usually in situations in which the assets include closely held corporations or otherwise require the special knowledge of an accountant.[27] The fact that the accountants were the decedent's accountants appears to be relevant because of their presumed familiarity with the decedent's assets.[28]

If the fiduciary or the attorney elects to engage an accountant to perform routine duties, pays for those services with estate or trust funds and lists the payments as administration expenses in the accounting, unless the services are clearly warranted by the complexity of the trust or estate, a duly diligent beneficiary's attorney is likely to object to those payments, and courts have sustained such objections.[29]

IV. The Criteria for Approval of Fees in a Judicial Accounting Proceeding Are More Extensive Than in an Action for Damages for a Client's Breach of a Retainer Agreement

In an action to recover professional fees from a client for services not involving a trust or estate, "traditional contract principles" apply, although courts do take special care to make sure that the attorney did not take unfair advantage of the client.[30]

In proceedings seeking the Surrogate's approval of professional services paid by a fiduciary, however, the criteria extend beyond contract principles.[31] Judge Brietel's opinion in *In re Freeman* set forth the factors to be considered as follows:

> [T]ime and labor required, the difficulty of the questions involved, and the skill required to handle the problems presented; the lawyer's experience, ability and reputation; the amount involved, and benefit resulting to the client from the services; the customary fee charged by the Bar for similar services; the contingency or certainty of compensation; the results obtained, and the responsibility involved.

Many of those factors might not be relevant in a plenary action for the payment of professional fees.

Unless the retainer agreement promises a particular result, or unless the issue is *quantum meruit*, absent fraud, over-reaching or unconscionability, the provider suing for his fees would not have to demonstrate that he produced a favorable result,[32] which is one of the criteria that Surrogates consider.[33]

Whereas private parties are entitled to request and should have to pay for professional services whether or not a court deems them to be reasonably necessary, EPTL 11-1.1(b)(22) authorizes a fiduciary to pay only "reasonable and proper administrations expenses . . . and any reasonable counsel fees he may necessarily incur." However, where a litigious or uncooperative beneficiary causes the fiduciary's counsel to perform extra legal services that would not be required under normal circumstances, that party will not be heard to object to the extra legal fees caused by his or her actions and behavior.[34]

Whether the services were of any particular value to the estate or trust is an issue considered by Surrogates.[35] In a dispute over fees with private parties, however, the fact that the services turned out to be of little or only modest value to the client would not warrant a reduction in an agreed-upon fee.[36]

Similarly, a private party is perfectly free to hire and pay an accountant to perform routine bookkeeping services, but if fiduciaries hire accountants to keep the books of account, reconcile bank and brokerage statements and check the daily fluctuations of the estate's or trust's securities, functions which the fiduciaries are expected to perform themselves, the fiduciaries will be required to absorb the cost out of their commissions.[37]

Whether the fees, though reasonable in the abstract, might be deemed excessive in relation to the size of an estate or trust is an issue which the Surrogate considers.[38] If a private party elects to secure professional help for a relatively minor matter, the fee he contracts to pay will not be reduced based on the amount involved unless the fee in context is deemed to be unconscionable.[39]

Other criteria applicable to the Surrogate's review that would not normally be an issue as between private parties are whether the provider exhibited such skill in performing those services as to warrant the fees it received;[40] whether the provider had particularly impressive professional credentials;[41] and whether the efforts involved any particular difficulties.[42]

If a private party engages an attorney to provide services to a third party, the provider's right to be paid by the party who engaged him is not normally affected. However, where a fiduciary asks an attorney to perform services for the benefit of a beneficiary, the Surrogate would be likely to sustain an objection to the use of trust or estate funds to make that payment.[43]

V. The Statute of Limitations

In New York, the statute of limitations does not start to run against a beneficiary's right to object to the fiduciary's payment of professional fees unless or until the fiduciary's account is submitted for judicial settlement or the fiduciary otherwise repudiates the trust.[44] Even the resignation of a trustee does not commence the running of the statute of limitations unless it is accompanied by a repudiation of the trust.[45]

The obvious reason for this rule is that the trust beneficiaries are not charged with knowledge of the fiduciary's transactions until the fiduciary states and renders an account. While corporate fiduciaries typically provide beneficiaries with monthly statements that reflect the fees paid during that period to attorney or accountant providers of services, the mere fact that an amount was billed and paid does not provide the beneficiary with the kind of information needed to evaluate whether the fees were fair and reasonable.

In order to provide the beneficiaries with the information they need to evaluate professional fees, Surrogates require affidavits of services to be filed along with the fiduciary's account.[46]

An SCPA 2110 proceeding can be commenced at "any time" during the administration of an estate or trust. Thus, attorneys are in a position to protect themselves against having to defend dated services. However, as noted above, trust accountings often span one or more decades, and accountants are not in a position to demand judicial approval of the fees they received except as part of the fiduciary's judicial accounting.

VI. Can Providers Avoid Having to Defend Their Fees Many Years After the Services Have Been Performed Pursuant to Criteria That Are Not Applicable to Their Work for Other Clients?

Under SCPA 2110, attorneys have the statutory right to petition the Surrogate to review and approve their fees whether or not they have been paid. While the statute provides that the petition can be filed "at any time during the administration of an estate," in practice, the Surrogate may refuse to entertain the petition until an accounting is filed, allowing the fees of each attorney to be evaluated in relation to all of the other professional fees paid or sought.[47]

Attorneys are not entitled to compensation for their time in seeking approval of their fees.[48] Thus, the down side of an SCPA 2110 application is that counsel will have to absorb the charges for the preparation of their petition and affidavit of services.

Accountants who do not wish to be in that predicament may protect themselves by demanding at the outset of their engagement that they be allowed to bill and be paid by the fiduciaries or by counsel, who can then treat the accountants' fees as disbursements without listing them as separate administration expenses.

If the attorneys' fee application includes payments to accountants as a disbursement, or if the accounting shows that the fiduciary was reimbursed from the estate for amounts paid to an accountant, and the Surrogate refuses to allow the reimbursement, the attorney or the fiduciary will be at risk, and may be required to absorb some or all of the fees in the same way as other items of expense that are not approved for reimbursement, such as postage, photocopying and the like.[49]

Fiduciaries and attorneys can protect themselves by including in the engagement letter with the accountant a proviso that the fees are subject to approval by the Surrogate. Then, if the Surrogate disallows the disbursement, the fiduciary and the attorneys may seek a refund from the accountant.

Retainers and letters of engagement with fiduciaries and beneficiaries sometimes contain provisions stating that if the Surrogate does not approve the fee for reasons other than the fair value of the services (i.e., a limitation based on the size of the estate, the results achieved or the value to the estate), the provider could seek the balance due from the fiduciary or from the beneficiary-client.

A 1997 decision in the First Department noted that a decision on fees by the Surrogate did not collaterally estop counsel from seeking the balance due from the client individually.[50] However, if there is a hearing with testimony from parties and witnesses, and the Surrogate makes findings of fact, there is every reason to believe that the factual findings will carry over to an action against the client, individually, especially if the rejection is based on findings that the provider exaggerated his time or was guilty of some other transgression.

Settling an account informally with receipts and releases will not prohibit the Surrogate from later examining the fees *sua sponte*. Therefore, in order to bind the beneficiaries, the informal accounting should include affidavits of services with time records and bills attached that describe the services in sufficient detail to warrant a court's enforcement of the releases.

However, if counsel and the fiduciaries incur the cost and expense of preparing an accounting in judicial format with that degree of data and detail regarding professional fees, they might as well prepare a petition and citation and submit it for court approval rather than simply securing beneficiary consent.

VII. Conclusion

Unless or until the Legislature enacts changes to the current state of the law, professional providers of services should understand that their fees are subject to court approval, and should recognize that they have to retain their records and bills, and be prepared to defend their fees, no matter how many years elapse from the performance of the services to the filing of an accounting.[51]

A few helpful practical suggestions in light of the current state of the case law are:

A) Firms which provide professional services should require that before retirement or withdrawal each member execute affidavits of services for each matter that the member handled for the firm where the firm's fees have not yet been judicially approved. Those affidavits should be stored and maintained together with the retainer agreements, engagement letters, bills and time records. Such a requirement is obviously burdensome and may not be practical if the departure is sudden or unexpected. However, firms with an extensive trust and estate practice should consider the nightmare of having to justify more than a hundred thousand dollars of legal fees without an affidavit of services from anyone with knowledge, and take such precautions as they deem appropriate.

B) If the fees paid to non-attorney professional providers of services are not likely to raise any eyebrows, the cost and expense to the providers of having to prepare affidavits detailing those services might be avoided, at least at the outset, if payments of the fees are treated as disbursements and made with checks drawn on the counsel's or the fiduciary's bank accounts, and not on the trust's or estate's bank accounts. Thus, when the accounting is ultimately filed, the fact that such fees will not be separately identified as administration expenses on Schedules C or C-1, will avoid the need to include affidavits from those providers, at least at the outset. However, if objections are raised to the fiduciary's or counsel's request for approval of their fees (which will result in disclosure of those payments as disbursements), or if the total of fees and disbursements is sufficient to warrant the *sua sponte* intervention of the Surrogate, then the fees may ultimately have to be justified and supported by affidavits.

C) Retainer agreements with professional providers of services should, therefore, be explicit with respect to what the parties' rights are in the event the Surrogate disapproves of all or any part of the professional fees and disbursements.

Endnotes

1. *Stortecky v. Mazzone*, 85 N.Y.2d 518 (1995). *See also In re Lafferty*, 297 A.D.2d 469 (1st Dep't 2002) (sustaining the Surrogate's right to review fees even though they were the result of a negotiated agreement in which the Attorney General participated).
2. Under SCPA 209(6), the Surrogate's Court is given jurisdiction "to determine any and all matters relating to lifetime trusts."
3. *In re Colangelo*. N.Y.L.J., 9/7/06, p. 31, col. 3 (Surr. Ct., Westchester Co) (Accountants required to file an affidavit of services). *See also In re Goodstein*, N.Y.L.J., 2/14/96, p. 35, col. 5 (Surr. Ct., Westchester Co.) (Surrogate reviews all professional fees).
4. SCPA 2208(1)(d) and 3(b).
5. MHL § 81.31.
6. EPTL 9-1.1 (lives in being plus 21 years).
7. *See In re Valente*, 24 A.D.2d 945 (4th Dep't 1965) (the accounting covered a period of 26 years).
8. *In re Capone*, 258 A.D.2d 581 (2d Dep't 1999).
9. *See In re Fechter's Estate*, 25 Misc. 2d 229 (Surr. Ct., N.Y. Co. 1960); *In re Amuso's Estate*, 18 Misc. 2d 936 (Surr. Ct., N.Y. Co. 1959).
10. *See In re James' Estate*, 86 N.Y.S.2d 78 (Surr. Ct., N.Y. Co. 1948) (Surrogate could order refund and was not required to surcharge the fiduciary responsible for the overpayment of fees). In *In re Lange's Estate*, 172 Misc. 437 (Surr. Ct., N.Y. Co. 1939), a payment to an estate creditor in excess of his correct share subjected the executor to a surcharge, but the decree instead directed the executor to secure a refund.
11. SCPA 209 provides for the Surrogate's jurisdiction over lifetime trusts and Surrogates entertain SCPA 2110 petitions dealing with lifetime trusts.
12. *In re Kottle's Estate*, 13 Misc. 2d 220 (1958).
13. *In re Musil*, 254 App. Div. 765 (2d Dep't 1938) (In a proceeding commenced under § 217 of the Surrogate's Court Act, the predecessor to 2101 and 2102 of the SCPA, the Surrogate was directed to determine whether the engagement of accountants was reasonably necessary).
14. *In re Steel*, N.Y.L.J., 4/12/94, p. 24, col. 4.
15. *See In re Colangelo, supra; In re Goodstein, supra; In re Steel, supra.*
16. *In re Acker,* 128 A.D.2d 867 (2d Dep't 1987).
17. *Stortecky v. Mazzone, supra; In re Lafferty, supra; In re Colangelo, supra*; *In re Goodstein, supra*; *In re Steel, supra*.
18. *In re Middagh*, 267 A.D.2d 593 (3d Dep't 1999); *In re Steel, supra.*
19. *See In re James' Estate, supra*. *See also In re Lange's Estate, supra; In re Stern, supra; In re Dewar's Estate. supra*.
20. *Stortecky v. Mazzone, supra*; *In re Lafferty, supra; In re Meng*, 227 N.Y. 264, 269-270 (1919); *In re Schanzer*, 11 Misc. 2d 893 (Surr. Ct., N.Y. Co. 1958), *rev'd*, 7 A.D.2d 275 (1st Dep't 1959), *aff'd*, 8 N.Y.2d 972 (1960); *In re Nicastro,* 186 A.D.2d 86 (2d Dep't 1992); *In re Gomez, supra; In re Colangelo, supra.*
21. *In re Meng*, *supra* (retainer agreements with fiduciaries must be fair and reasonable). See Turano & Radigan, N.Y. Estate Administration (1993) § 13.04, p.445 ("No retainer agreement can bind an estate to more than a reasonable fee"). *See also In re Steel, supra*. In *In re Gomez,* 5 Misc. 3d 534 (Surr. Ct., N.Y. Co. 1994), the court directed counsel to file an affidavit of services in support of the fee claimed under a contingent fee agreement between counsel and survivors of the terrorist attack on 9/11 who secured awards from the Victim's Compensation Fund established by Congress. The opinion noted that the creation of the Fund eliminated the contingency and required counsel to prove the value of their services.
22. *In re Badenhausen*, 38 Misc. 2d 698 (Surr. Ct., Richmond Co. 1963) (Executor surcharge for payments to bank for routine record keeping); *In re Acker, supra* (Trustee surcharged for payments to accountant found to be unwarranted).
23. Judiciary Law § 474; *Greenberg v. Remick & Co.*, 230 N.Y. 70 (1920).
24. *See In re Lange's Estate, supra*, where the decree directed the executor to secure a refund. *See also In re Meng, supra*; *In re Steel, supra. See* Turano & Radigan, N.Y. Estate Administration (1993), *supra*.
25. *See In re Valente, supra*, where the Fourth Department acknowledged that the 26 years covered by the accounting

might have involved matters that justified the retention of the accountant, but remanded the case to the Surrogate for further review because the accountant's affidavit of services failed to show that the services were reasonably necessary in light of the fact that a custodian bank had been engaged and received fees for handling the trust's securities.

26. *In re Schoonheim*, 158 A.D.2d 183 (1st Dep't 1990) (routine accounting services are charged against the amounts allowed for attorneys' fees); *In re Acker*, 128 A.D.2d 867 (2d Dep't 1987) (denying approval for accountants' fees that involved routine matters); *In re Oikile,* N.Y.L.J., 12/1/99, p. 31, col. 3 (Surr. Ct., N.Y. Co.) (absent a showing of necessity, counsel must bear the expense of the accountants' fees); *In re Smith,* N.Y.L.J., 1/15/98, p. 36, col. 6 (Surr. Ct., Nassau Co.) (even if there are no objections, the Surrogate can review and charge accountants' fees against the attorneys' compensation); *In re Nugent*, N.Y.L.J., 4/17/95 p. 35 col. 5 (Surr. Ct., Westchester Co.) (absent a showing of special difficulty, there is no cause for counsel to retain an accountant to prepare the accounting whether or not it is in judicial format); *In re Paris*, N.Y.L.J., 9/22/94, p. 33, col. 4 (Surr. Ct., Kings Co.) (routine tax returns are the responsibility of counsel); *In re Steel, supra* (despite express authority in the will to engage the accountant, his fee when added to the attorneys' fees could not exceed a reasonable attorney's fee and the Surrogate disallowed a portion of the accountant's fee).
27. *In re Tuttle's Estate*, 4 N.Y.2d 159 (1958) (tax proceedings with the IRS); *In re Berg,* 91 Misc. 2d 939 (Surr. Ct., N.Y. Co. 1977) (the accountant's affidavit of services showed that the services involved the valuation of the estate's interest in a stock brokerage firm, which was beyond the normal scope of the attorney's or fiduciary's function); *In re Greene*, 47 Misc. 2d 140 (Surr. Ct., N.Y. Co. 1965) (allowing some of the accountant's fees based on the nature of the estate's assets, but rejecting fees for tasks that normally could have been performed by fiduciaries or their counsel); *In re Cohen*, N.Y.L.J., 12/5/97, p. 35, col. 1 (Surr. Ct., Nassau Co.) (the estate included shares in real estate limited partnerships but the Surrogate held that approval required a showing that the attorneys did not also charge for those same services); *In re Hanover*, N.Y.L.J., 6/19/98, p. 29, col. 2 (Surr. Ct., Kings Co.) (the court approved some of the accounting fees and applied the rest against the allowance for legal fees).
28. *In re Jadwin,* 58 Misc. 2d 809 (Surr. Ct., Suffolk Co. 1969) (decedent's accountant and his familiarity with the estate assets was a factor to be considered, but the court determined that the bulk of his fee was for services that were personal to the deceased executor and denied those fees).
29. *In re Schoonheim*, *supra*; *In re Acker, supra*; *In re Oikile*, *supra*; *In re Hanover*, *supra*.
30. *King v. Fox*, 7 N.Y.3d 181,191 (2006).
31. See *In re Freeman*, 40 A.D.2d 397 (4th Dep't 1972), *aff'd*, 34 N.Y.2d 1 (1974) and *In re Potts*, 123 Misc. 346 (Surr. Ct., Columbia Co. 1924), *aff'd*, 213 App. Div. 59 (4th Dep't 1925), *aff'd without opinion*, 241 N.Y. 593 (1925), and their progeny.
32. *See Summit, Solomon & Feldesman v. Matalon,* 216 A.D.2d 91 (1st Dep't 1995), *appeal denied*, 86 N.Y.2d 711 (1995).
33. *See In re Kaufmann*, 26 A.D.2d 818 (1st Dep't 1966).
34. *In re Matrone*, N.Y.L.J., 4/15/02, p. 23, col. 1 (Surr. Ct., Bronx Co).
35. *In re Middagh*, 267 A.D.2d 593 (3d Dep't 1999) (accountants directed to refund payments for services that were of no value to the estate).
36. *Summit Solomon & Feldesman v. Matalon*, *supra.*
37. See cases cited above in note 20.
38. *In re Kaufmann*, 26 A.D.2d 818 (21st Dep't 1966), *aff'd*, 23 N.Y.2d 700 (1968) (the size of an estate operates as a limitation on the amount approved); *see also In re Wallace*, N.Y.L.J., 7/26/90 p. 29, col. 3 (Surr Ct., Westchester Co.).
39. See 7 NY Jur 2d Attorneys at Law § 178.
40. *In re Brehm*, 37 A.D.2d 95 (4th Dep't 1971); *In re Kentana*, 170 Misc. 663 (Surr. Ct., Kings Co. 1939).
41. *In re Warhol*, 165 Misc. 2d 726 (Surr. Ct., N.Y. Co. 1995), *modified on other grounds*, 224 A.D. 2d 235 (1st Dep't 1996).
42. *In re Gans*, N.Y.L.J., 5/4/93, p. 22, col. 5 (Surr. Ct., N.Y. Co.).
43. *In re Baxter*, 196 A.D.2d 186 (4th Dep't 1994), *leave to appeal denied*, 84 N.Y.2d 808 (1994).
44. *In re Barabash*, 31 N.Y.2d 76, 80 (1972); *In re Taylor's Estate*, 30 A.D. 213 (2d Dep't 1898); *In re Walls' Guardianship*, 179 Misc. 924 (Surr. Ct., Nassau Co. 1942); *In re Beard's Estate*, 141 Misc. 888 (Surr. Ct., Kings Co. 1931).
45. *In re Singer*, 12 Misc. 3d 621 (Surr. Ct., N.Y. Co. 2006), *aff'd*, 30 A.D.3d 211 (1st Dep't 2006).
46. *In re Valente, supra; In re Colangelo*, *supra; In re Goodstein*, *supra*; *In re Berg, supra*; *In re Gomez*, *supra*.
47. *In re Will of Mergentime,* 155 Misc. 2d 502 (Surr. Ct., Westchester Co. 1992) (where co-fiduciaries each retained separate counsel the aggregate allowance should not exceed the fee that would have been charged by a single attorney representing both); to the same effect *see In re Kentana, supra*; *see also In re Cohen*, *supra*; *In re Steel, supra*.
48. *See Estate of Dorothy Kaplan*, N.Y.L.J., 5/15/00, p. 32, col. 6 (Surr. Ct., Kings Co.) (Attorneys are not entitled to charge the estate for the application for approval of their fees); *see also to the same effect Estate of Catherine Gallagher*, N.Y.L.J., 2/2/93, p. 22, col. 4 (Surr. Ct., Bronx Co.).
49. *See In re Diamond*, N.Y.L.J., 10/23/92, p. 26, col. 6 (Surr. Ct., Westchester Co.), *aff'd*, 219 A.D.2d 717 (2d Dep't 1995); *In re Zalaznick*, N.Y.L.J., 11/19/76, p. 11 col. 1 (Surr. Ct., Bronx Co.), *aff'd*, 61 A.D.2d 772 (1st Dep't 1976).
50. *Bomba v. Silberfein*, 238 A.D.2d 261.
51. *In re Middagh*, 267 A.D.2d 593 (3d Dep't 1999) (attorneys' failure to keep good records of their time resulted in a reduced fee).

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The New Frontier: Non-Charitable Estate Planning Transfers with Fractional Interests in Art (and Other Personal Property)

By Lance S. Hall, ASA

Over the last few decades, it truly has been the best of times for collectors of art (and other collectibles). In 1961, the record price paid for a painting was $2.3 million.[1] By 1970, the record price had increased to $5.5 million[2]—a compound annual return of 10.2 percent. In 1980, the record price had increased to only $7 million.[3] However, by 1990 the record price had reached an astounding $53.9 million[4]—a compound annual return of 11.5 percent annually since 1961. By 2004, the record price almost doubled to $104.1 million[5] and by 2006, the record price had increased to $140 million.[6] In fact, Jianping Mei and Michael Moses, the developers of the Mei/Moses Art Index, report that on average, post-war and contemporary art prices increased by 45 percent in 2006 alone.[7] Much of the rapid acceleration in art prices in recent years is being attributed to the unprecedented increase in compensation for Hedge Fund and Private Equity Fund managers, the rapid increase in wealth in emerging countries, and even Wal-Mart heiress Alice Walton's aggressive collecting for her Crystal Bridges Museum of Art scheduled to open in 2009.[8]

Regardless of the reason for the run-up in art values, art collectors comprise a significant market segment with substantial wealth that requires complex estate planning.

Charitable Gifting

Historically, the most popular estate planning technique for art collectors was contributing fractional interests in art to charities (often, gifting to museums). *The New York Times* reported that The Museum of Modern Art "has 650 works [of art] that began as partial gifts. . . ."[9] Under the tax laws as they existed prior to August 2007, this made sound economic sense. Because of personal property charitable deduction limitations based on taxable adjusted gross income, a fractional interest charitable gift could be engineered to achieve the best tax deduction outcome. In addition, a taxpayer could donate a one-tenth interest in a $20 million painting and receive a $2 million charitable deduction without having to discount the value for lack of control and lack of marketability normally associated with a fractional interest. Moreover, in future years, if the painting increased to $30 million, the art investor could make another one-tenth interest gift and receive a deduction equal to $3 million (one-tenth the appreciated price).

On the downside, the charity now had the right to display the painting for a number of days equivalent to the fractional interest percentage.

With the passage of the 2006 Pension Protection Act ("Act"), significant changes were made that have put a chill on fractional interest charitable donations. Prior to the Act, the value of the charitable deduction was based on the percentage gifted multiplied by the fair market value of the entire painting at the time of the gift. Under the Act, however, the deduction for subsequent partial interest gifts is based on the percentage gifted multiplied by the fair market value of the painting when the initial gift was made.[10] In other words, if the painting increases from $20 million to $30 million between the time of the initial partial interest gift and any subsequent gift, the value of a 10 percent donation will be limited to $2 million. Worse, for estate tax purposes, the value of the partial interest retained at death will be based on the fair market value of the painting as of the date of death (or alternate valuation date).[11] This problem is further exacerbated by the common practice of gifting the post-death partial interest remaining in the estate to the same charity. In such cases, the estate will receive a charitable deduction based on the pro-rata fair market value used for the initial partial interest gift, yet be subject to an estate tax based upon the fair market value of the painting as of the date of death (or alternate valuation date).

The Act also allows for a recapture of any deduction unless the donor gifts all of the remaining interests in the art within 10 years of the initial partial interest gift or the date of death, whichever is earlier.

As a result of the Act, fewer fractional interests in art (and other personal property) will be donated to charities. Therefore, estate planning for the art collector/investor will now turn to outright gifts or discounted fractional interest transfers to junior generations.

Undivided Interests

For those art collectors or investors who want to pass their collections to their heirs, the gifting of undivided interests (i.e., fractional interests) in personal property may be advantageous. The courts have long recognized that undivided interests in real estate should be subject to discounts from its otherwise pro

rata value due to lack of control and lack of marketability. Moreover, since 1993, the average discount allowed by the tax court for undivided interests in real property has increased from approximately 15 percent to 29 percent.[12] The key question, however, pertains to whether such discounts are applicable to personal property.

Rights and Restrictions of an Undivided Interest Owner

Co-owning an asset is inherently problematic. Accordingly, a myriad of federal and state laws and their interpretation by the courts exist to minimize the problems and maximize the probability for success. To avail investors with the greatest set of protections with a minimum amount of risk, the vast majority of commercial enterprises are structured as corporations, subchapter S-corporations, limited liability companies and partnerships. It is not unusual to have lengthy and complex agreements outlining the rights, preferences and privileges of each of the owner classes. Perhaps, most importantly, rights and limitations on control are clearly spelled out.

With undivided interests, however, normally there is no operating agreement. Accordingly, state law will outline basic rights, preferences and privileges to be accorded an undivided interest owner. Generally, these rights are:

1) the right to occupy or possess;
2) the right to use;
3) the right to operate;
4) the right to lease; and
5) the right to partition.

Given the fact that each undivided interest owner has the same rights, it is not uncommon for disagreements to arise. In a real estate context, disagreements can arise regarding how to use the property, who should lease it and at what rates, what expenses should be incurred, how the property should be maintained, etc. Nonetheless, as real estate investors are typically seeking to maximize current income, this united profit incentive is likely to reduce disagreements relative to non-income producing assets.

Investors in art and other personal property, which is typically held for appreciation and not current income, are likely to encounter more reasons for disagreements. Who will decide where the art is displayed? Who will pay the insurance? If the art is moved among the fractional interest owners, who will move the art? Who will pay if damage occurs? How will periodically moving the art affect insurance? How will security be provided when on display or when moved? What recourse is there if one owner doesn't transfer the art for display purposes to the other partial interest owner?

Another downside to owning undivided interests is lending institutions will typically not lend for the purpose of acquiring an undivided interest where the undivided interest is the sole collateral for the loan. As there is no marketplace for the transfer of undivided interests, lending institutions have no way of quickly liquidating the collateral if the terms of the loan are not being met.

Because legislatures recognized the potential for disagreements that may arise that not only harm the parties, but perhaps even the underlying asset, states grant undivided interest holders the right to partition the property. A partition of property is generally performed as a physical division (based on value and property attributes) or as a partition by sale, whereby the property is sold and the cash divided proportionally to the ownership of the asset. Theoretically, such a partition could be performed relatively quickly. However, in practice, partition actions involving real property could easily take two to five years.[13]

How the Courts View Undivided Interest Discounts in Personal Property

On the rare occasion when an undivided interest in personal property has made it to tax court, the court has generally been unsympathetic. There have now been five cases that have addressed the subject.[14] Three of the five cases involved personal property such as equipment, vehicles, furniture and household goods.[15] In each of the three cases, the personal property was not the sole or the most significant asset in controversy. In each of these three cases the court did not allow a discount for undivided interests in personal property. In one of the three cases, the property was sold after the valuation date by agreement among the undivided interest holders.[16] This sale was considered by the court. In two of the three cases, the court indicated that the taxpayer did not meet its burden of proof.

Of the other two cases, one dealt with a 65 percent interest in a collection of over 350 paintings that was the subject of ongoing litigation arising from a divorce at the time of death.[17] Moreover, most of the art collection was sold at auction 10½ months after the date of death. The court deftly avoided any meaningful discussion of an undivided interest discount and instead granted a 5 percent discount for "litigation uncertainties" associated with ongoing divorce-related litigation.

Estate of Stone

Finally, on May 25, 2007, a federal court reached a decision regarding whether an undivided interest discount is warranted for a 50 percent interest in

19 paintings and, if warranted, what the appropriate magnitude of the discount is.[18] While the court clearly rejected the IRS's contention that no discount was warranted, the court also rejected the taxpayer's expert's discount approaches and conclusions.

The experts for the IRS included an individual from the Art Advisory Panel.[19] The experts testified that they were aware of undivided interests in art changing hands at no discount. However, no detail was provided regarding these sales. And, apparently, no investigation of the assertion was performed by the taxpayer's attorney. Nonetheless, it was clear that the court gave significant weight to the IRS's experts' conclusions, stating:

> [A] hypothetical seller who is under no compulsion to sell would not accept the 44 percent discount proposed by the Plaintiffs. Given [the IRS's experts'] long history in buying, selling, and appraising art and . . . experience in working with art experts on art appraisals for more than thirty years, this is persuasive evidence that a hypothetical willing seller would not sell a fractional interest in art at a discount.
>
> A holder of such interest who . . . is under no compulsion to sell would either seek to sell the entire work of art—with the consent of other co-owners or via an action to partition—and take his or her appropriate share of the proceeds, or sell the partial interest at a price equivalent to his or her fair share of the proceeds of such sale. The hypothetical willing seller would know that he or she had the right to partition and would therefore not accept any less for his or her undivided interest than could be obtained via partition.

The taxpayer's expert utilized four approaches to determine the amount of the discount. Three of the four approaches utilized analogies to undivided interests in real estate and real estate holding entities.[20] The court considered and rejected the taxpayer's expert's discount valuation and stated, "the art market differs from the real estate or business market. Art is simply not fungible. . . . More importantly, although there is evidence that partial interests in real estate have been sold at a discount, there is no evidence that similar sales have also occurred in the art market."

Despite the rejection of the taxpayer's conclusions, the court clearly did not want to intervene and essentially punted, stating:

> Based on the evidence presented by the parties, it is difficult to discern precisely what the appropriate discount for such uncertainties [of partition] should be. While this Court is capable of determining a discount if necessary, it finds it preferable to allow the parties an opportunity to further meet and confer on this issue. . . . When meeting and conferring on the appropriate discount, the parties shall keep in mind the Court rejects many of the assumptions underlying Plaintiffs' expert's report, but it also finds that the government's experts have failed to address the valuation of the Estate's undivided interest properly. . . . If the parties are unable to reach agreement on the appropriate amount of the Plaintiffs' tax refund, then this Court will decide on an appropriate discount that falls somewhere between the 2% discount proposed by the government and the 51% cost-to-partition discount proposed by the Plaintiffs, based on the evidence presented at trial and keeping in mind that Plaintiffs bear the burden of proof.

Ultimately, the two parties could not agree and went back to the court to determine the discount.[21] This time, while continuing to proclaim that no discount was appropriate for undivided interests in personal property, the IRS "in a spirit of compromise" agreed to no more than a 5 percent discount. On the other hand, the taxpayer had dropped their claim of a 44 percent discount and sought a discount "of at least 35%."

In its final decision the *Stone* court reiterated its dissatisfaction with the taxpayer's expert's analysis stating, "collectors of art are often drawn to the aesthetics of a particular work of art, rather than viewing art simply as an investment vehicle. Plaintiff's expert's methodology is flawed because it fails to take this fact into account."

On the other hand, the court noted that the IRS's offer of a 5 percent discount, after subtracting out legal and sales fees, left only a "1.2% discount for the uncertainties involved in waiting for the partition action to become resolved." The court further noted that the 1.2 percent discount allocable to the uncertainties of partition "appears relatively low."

In deciding the appropriate discount, the court noted that the taxpayer had failed to carry the burden of proof, and for the court to arrive at "any discount other

than that to which the government has already agreed would be impermissibly arbitrary."

It is important to note, however, the judge felt that a five percent discount was "relatively low" to reflect the risks of partition. However, as the judge determined, the evidence presented by the taxpayer's expert failed to meet the taxpayer's burden of proof.

Proving the Discount (Meeting the Burden of Proof)

It has become common for courts to allow discounts for lack of control and lack of marketability in situations involving minority or partial interests in private equity, real estate holding entities and undivided interests in real estate. In the case of private equity, significant empirical data is available to indicate that a discount is warranted and, importantly, to provide a reasonable range of discounts. The same is true, but to a lesser extent, for real estate holding entities. However, for undivided interests in real property little empirical data exists. Nonetheless, since 1993 the courts have accepted discounts for undivided interests in real estate averaging 29 percent.[22]

With little empirical data, the success of the discount valuation expert will hinge on being able to make meaningful comparisons with other assets classes despite the "non-fungible" nature of art. The following provides analogies that this author believes will ultimately meet the burden of proof.

Lack of Empirical Data

It is true that no market exists that transacts in undivided interests in art or other personal property. Nonetheless, the lack of a market has not prevented the courts from accepting significant undivided interest discounts for real property. In *Estate of Williams*, the court stated, "[The] . . . inability to find sales of fractional interests in comparable real property . . . shows that there was no market for fractional interests in such property."[23] Importantly, without empirical data, the *Williams* court allowed a 44 percent undivided interest discount.

In *Forbes*, the court stated, "We are unsatisfied that any of the parties' experts have adequately justified their recommended discount rates—a shortcoming that might be attributable in part to a lack of available empirical data."[24] Despite this shortcoming, the *Forbes* court allowed a 30 percent discount for an undivided interest in real property.

When considering the marketplace for art, it is important to note that auction houses will not auction off undivided interests in art. Auction houses are the marketing arms of sellers wishing to attract buyers. An axiom of value is that when the potential pool of buyers is reduced, the value of the asset drops. As stated in *Baird*, an undivided interest in real estate case, "The fact that the market [for undivided interests] is severely limited drives prices down (increasing discounts)."[25]

Moreover, lenders will not lend on purchases of undivided interests in art where the undivided interest in art is the sole collateral. Without the ability to borrow and buy, the pool of potential buyers is further reduced. Such inability of the undivided interest holder to sell his or her interest should be expected to negatively impact the value.

A Discount Expert Is Not an Art Expert

A common complaint of the IRS is that often the discount valuation is performed by an individual who is not an expert in the valuation of the underlying asset and therefore does not meet the "qualified appraiser" standard. However, this argument was rejected by the court in *Estate of Williams*.

> [The IRS] argues that [the taxpayer's expert] was not qualified to value real property because he is a business appraiser and not a real estate appraiser. Respondent contends that [the taxpayer's expert] provided no factual basis for his conclusions that a 20-percent discount for lack of marketability should apply. [The IRS] points out that [the taxpayer's expert] included in his report as evidence of the appropriate amount for marketability discounts a discussion of the illiquidity of privately held companies and discounts relating to sales of their stock. Respondent argues that we should give no weight to [the taxpayer's expert's] opinion because he did not consider the marketability of real property. Respondent argues that [the taxpayer's expert's] use of a 30-percent discount for lack of control for the cost to partition the properties was not supported by any verifiable data in his report and far exceeds [the IRS's expert's] estimated costs of partition.
>
> We disagree that we should disregard [the taxpayer's expert's] report because he is not a real estate appraiser. [The taxpayer's expert] is an experienced business appraiser who has given expert opinions in valuing fractional interests in partnerships, businesses, and real property. We believe that he correctly considered various factors affecting the potential costs of par-

> titioning the properties in issue. He considered the time and expense of selling real property in that particular market. [The taxpayer's expert] appropriately considered all relevant facts and gave a reasonable explanation for the discount he applied to the property interests at issue here.

As of today, there are no "art appraisers" who are experts in determining discounts for lack of control and lack of marketability. These perplexing and complex issues are commonly addressed by many business valuation experts. It is these experts who are the ideal parties to testify regarding lack of control and lack of marketability for art and other personal property. The discount process involves two experts: the asset expert testifies to the underlying asset value and the discount valuation expert testifies as to the amount of the discount. The challenge for the discount valuation expert is to convincingly explain how data found in one market involving a particular asset can translate into another market involving an entirely different asset.

"The Hypothetical Willing Seller Would Know That He or She Had the Right to Partition and Would Therefore Not Accept Any Less for His or Her Undivided Interest Than Could Be Obtained Via Partition."

The above quote comes directly from the *Estate of Stone*. And, yet, a willing seller, despite having the right to partition, would accept a discount from the underlying appraised value. Time and again, the courts have addressed this issue as it pertains to undivided interests in real estate. Despite involving a different type of asset—real estate—the court's comments ring true for undivided interests in art and other personal property. In the *Estate of LeFrak*, the court rejected the exact argument against a discount saying that in addition to the cost of partition, a valuator must consider the "uncertainty, and delays attendant upon partition proceedings as the basis for allowing a discount in valuing fractional interests in real property."[26]

The Discount Is Not Limited to the Cost of Partition

The *Estate of Williams* court echoed the *Lefrak* court and stated that relying solely upon the cost-to-partition "does not give adequate weight to other reasons for discounting a fractional interest in real property, such as lack of control and the historic difficulty of selling an undivided fractional interest in real property. . . ."[27] Undivided interests in real estate do not have a monopoly on these problems. Certainly, undivided interests in art lack control and an art investor or collector would have difficulty in selling an undivided interest.

A Partition Action Takes Considerable Time

By stating that an undivided interest holder of art would not sell the undivided interest for less than its pro-rata underlying value, the *Stone* court ignores a primary tenet of "fair market value"—liquidity has value. No discount is applicable only if one assumes that the undivided interest holder can force a sale of the underlying asset and receive cash within a short period of time. Nothing could be further from the truth! Consider the difficulties of Robert and Ethel Scull. In their divorce it was determined that Robert owned 65 percent and Ethel owned 35 percent of an extensive collection of art constituting over 350 pieces. On April 9, 1975 Ethel filed for divorce. On October 19, 1981 Ethel Scull was granted a divorce. On March 28, 1985 the court determined that she owned 35 percent of the paintings. Robert and Ethel were directed by the court, based upon an initial flip of a coin, to alternately select paintings until Ethel's 35 percent of the value was achieved. On December 28, 1985 the court stipulated what appraised values of the paintings were to be used in making the in-kind distribution. On January 1, 1986 Robert died. On January 31, 1986 Ethel appealed. On March 14, 1986 the art collection was divided in accordance with the March 28, 1985 ruling. On November 10, 1986 the works of art selected by Ethel Scull were sold at auction. In February 1987, the court rejected Ethel's appeal. In 1989 and 1990 other claims made by Ethel were settled by the estate.[28]

The above story is illustrative of the potential problems that can arise when co-owners disagree. It is generally agreed that the delays in partitioning can be extensive for undivided interests in real estate. In *Baird* the court noted that "the delay associated with partition is at least 1 year, but is more likely to take several years."[29] In *Barge* the tax court assumed a 4-year partition time frame.[30]

Delays in partitioning are related to the potential for disagreement among the owners. Accordingly, it is accepted that the more undivided interest owners, the greater the likelihood of disagreement. As noted in *Baird*, ". . . the problems encountered [with undivided interests] increase[ ] as the number of fractional owners increases."[31]

Similarly, the increase in the number of paintings or other personal property will also affect the partitioning time frame. With a greater number of paintings or other personal property, it will be more difficult to come to an agreement on a partition action, whether in-kind or by sale.

Moreover, when comparing art to real estate, the potential for disagreement is greater with art. As the

Stone court stated, “Art is simply not fungible. . . .” In other words, art cannot simply be replaced by another “like kind” asset. The very purpose of art is to elicit emotion. This emotional context has the realistic potential to make ownership of undivided interests in art particularly difficult. Disagreements are likely to be more intense because the issues are personal, not economic. As a result, an art partition action is likely to be more contentious, drawn-out and expensive than when dealing with undivided interests in real estate, and the prospect of arriving at a reasonable settlement more remote.

Lack of Control

It is interesting that none of the personal property discount cases mention lack of control or lack of marketability. However, real estate undivided interest cases are replete with cautions to consider the lack of control over the investment during the partition time frame. In *Stevens*, the court reminded the IRS that “[w]e do not limit the discount to the costs of partitioning because such a discount does not account for the factors of control and marketability. . . .”[32] Control has value. Until a partition action is completed and the art is sold or physically divided, the undivided interest owner does not have control. Accordingly, a buyer of an undivided interest in art would offer a price lower than the prorata share of the appraised value of the whole, and the willing seller would be willing to accept a lower value because he or she lacks control over the art.

Lack of Marketability

As has already been shown, the right to partition does not confer liquidity or marketability upon the undivided interest holder. Moreover, given the uncertainties involving the costs, time frame and potential outcomes involved in a partition action, such a discount should be substantial. One of the key considerations for lack of marketability is related to uncertainty. In investments we often refer to this uncertainty as volatility. Restricted stock provides a meaningful example of the impact of volatility on the magnitude of the discount for lack of marketability.[33] The largest commercially available database examining the discounts from the publicly traded price in restricted stock transactions is The FMV Restricted Stock Study.™[34] The FMV Study contains data on nearly 500 restricted stock transactions. The FMV Study indicates that the 10 percent of the transactions with the highest volatility had a median discount from the otherwise liquid price of 46.4 percent. The 10 percent representing the lowest volatility stocks had an average discount of only 10.5 percent.

It is important to note that Rule 144 allows such restricted stock to be sold in the marketplace, without a discount, after the stock is held for one year (two years prior to 1997). Accordingly, the length of time that restricted stock is illiquid appears equal to, or less than, the length of time a partition action would be completed for art.

Real estate generally has lower price volatility than stocks. It is interesting to note that such discounts determined by the courts for real estate are generally lower than those allowed by the courts for private operating companies. In fact, this is supported by data involving private sales of real estate partnership interests in the secondary market.[35]

By examining the relative volatility of different investment asset classes, an indication of the magnitude of the discount can be assessed. In a recent report (“Report”) titled “A Simple Risk Reduction Tool: Time,” Merrill Lynch examined the return on and volatility of different asset classes since December 1969.[36] The Report concluded that the longer an asset is held, the lower the risk of loss. Importantly, the Report also noted that “Art, Gold and Commodities offered the least attractive risky (sic) reward potential providing inferior returns while generating SUBSTANTIALLY more risk” [emphasis added]. The Report found that if an investor holds art for 5 years, the risk of loss on a rolling 12-month basis was 17 percent for Art and only 10 percent for the Standard & Poor’s 500 index.

The leading art price index, the Mei/Moses Art Index, shows that in time periods of 5-years, 10-years, 25-years and since 1961, the standard deviation of returns (a measure of volatility or risk) for art always exceeds that of the Standard & Poor’s 500 index.[37] Since 1961, art’s standard deviation of returns has been 44 percent higher, on average, than the standard deviation of returns of the Standard & Poor’s 500.

Illustrating the potential risk (and volatility) when investing in art, data collected by Art Market Research show that the middle 80 percent of prices for Modern European Painting dropped 58 percent from 1990 to 1998.[38] During the same time frame, the Dow Industrials Index increased 254 percent.[39]

Anecdotal Evidence

In 1995, an accredited appraiser, Elin Lake Ewald, published the results of a study she performed regarding potential market reaction to the sale of a 50 percent undivided interest in two paintings.[40] Ms. Ewald interviewed 12 art dealers with at least 20 years of experience. Nine of those interviewed were members of the Art Dealers Association of America.

> The focus [of the interviews] was then on the offering of a 20% fractional interest in the two paintings, in which the remaining majority interest was held by members of a single family, and on whether the dealer would

> be interested in purchasing a minority interest. If so, would he or she be advised to pay the proportionate full price, and, if not, what would he or she anticipate offering for this interest? On what basis was this figure decided?

Only three dealers declined to indicate a discount. Of the remaining 9 dealers, "one dealer mentioned a figure of more than 50% (only if accompanied by control of the sale), and two less than 50 percent." Overall, the average discount recommended for the 20 percent undivided interest in the paintings was 50 percent.[41] This outcome appears consistent with the relatively higher price-volatility of art.

Waiver of the Right to Partition

With the *Stone* court's focus on the right to partition and the statement that a willing seller would not sell his or her interest for less than the underlying appraised value because of the right to partition, it may be sound estate planning to have the gift made subject to an agreement that waives the right to partition. Obtaining a waiver will focus the court's attention on the lack of control and lack of marketability of the interest, instead of the ability to force a sale through a partition process. This "operating agreement" may also spell out where and when the parties will display the art, as well as who will cover the moving, insurance and security costs.

No Majority Interest

When planning for discounting undivided interest transfers, it is important to note that there is no meaningful "majority" interest. Unlike voting stock, the 80 percent undivided interest owner has no more control than the 20 percent undivided interest owner. Accordingly, undivided interest transfers that leave the senior generation with an interest over 50 percent should still be able to command the full discounts associated with lack of control and lack of marketability.[42]

Summary and Conclusions

With the art market reaching new highs and investor interest in art exceeding previous norms, increased scrutiny to the estate planning needs of art collectors and investors is required. With the changes in the rules for charitable gifting under the 2006 Pension Protection Act, charitable gifts of art are no longer as attractive. Alternatively, fractional interest gifting to the junior generation may result in significant estate tax reduction. Even if a gift is not made, art investors/collectors in community property states may be able to avail themselves of undivided interest discounts at death.

Clearly, undivided interest discounts for art and other personal property are likely to incur close scrutiny and outright rejection by the IRS. However, under the principles of "fair market value" an undivided interest discount is applicable. The challenge will be convincing the court that an analysis with no empirical data involving actual undivided interest sales in art will meet the taxpayer's burden of proof. The courts have overcome identical difficulties associated with the lack of empirical data when discounting undivided interests in real estate. The issues are no different with art, collectibles and other personal property. An objective measure of the hierarchy of discounts applicable to different asset classes is to examine the relative volatility of the individual art or personal property with other classes of investments where empirical data is available (real estate is generally less volatile than stock and art, stock is generally less volatile than art, art is generally less volatile than gold and commodities). Then, the specific attributes of the art (or other personal property) could be used to more subjectively adjust the discount up or down, accordingly.

To focus the court's attention to the lack of control and lack of marketability of the interest, and away from the right to partition, a transfer made subject to an agreement to waive the right to partition is advisable.

With the charitable gifting no longer as advantageous, the estate planning professional can expect to see a significant rise in fractional interest discount planning for art (and other personal property).

Endnotes

1. Rembrandt, *Aristotle Contemplating the Bust of Homer*.
2. Diego Velazquez, *Portrait of Juan de Pareja*.
3. J.M.W. Turner, *Juliet and Her Nurse*.
4. Vincent van Gogh, *Irises*.
5. Pablo Picasso, *Boy with a Pipe*.
6. Jackson Pollock, *No. 5, 1948*.
7. Beautiful Asset Advisors, www.artasanasset.com.
8. Lee Rosenbaum, "The Walton Effect: Art World Is Roiled by Wal-Mart Heiress," *The Wall Street Journal* (October 10, 2007).
9. "Taxes: The Ins and Outs of Charitable Deductions," Jan M. Rosen, *The New York Times*, November 13, 2006.
10. The initial fractional interest charitable gift under the Act will be the first partial interest gift made after the Act even if partial interest gifts were made before the Act.
11. However, discounts for lack of control and lack of marketability may be applicable.
12. The average discount for post-1992 cases excludes *Estate of Young*, No. 20139-94 (May 11, 1998) and *Fratini v. Commissioner*, T.C. Memo. 1998-308 (August 28, 1998) because they were joint tenancies with the right of survivorship; *Estate of Shepherd*,115 T.C. No. 30 (October 26, 2000) argued as a partnership; *Estate of Wineman*, T.C. Memo. 2000-189 (June 28, 2000) and *Amlie v. Commissioner,* T.C. Memo. 2006-76 (April 17, 2006) each estate

asked for and was granted only a 15% discount; and *Estate of Tehan*, T.C. Memo. 2005-128 (May 31, 2005) lost on Section 2036 grounds.

13. The author was involved in a partition action study in the state of Hawaii. The time frames ranged from 9-months to 13-years, with the vast majority in the 2-year to 5-year time frame. In *Estate of Baird*, T.C. Memo. 2001-258 (September 28, 2001), the court noted testimony that "the delay associated with partition is at least 1 year, but is more likely to take several years." In *Barge v. Commissioner*, T.C. Memo. 1997-188 (April 2, 1997), the tax court assumed a 4-year partition time frame.
14. *Estate of Andrews*, 13 BTA 651 (1928*); Estate of Pudim*, T.C. Memo. 1982-606 (October 18, 1982); *Estate of Pillsbury*, T.C. Memo 1992-424 (July 27, 1992); *Estate of Scull*, T.C. Memo. 1994-211 (May 12, 1994); and, *Stone v. U.S.*, No. 3:06-cv-00259, No. Dis. of Cal. and *Stone v. U.S.*, 100 AFTR 2d 2007-5512 (August 10, 2007).
15. *Estate of Andrews*; *Estate of Pudim*; and *Estate of Pillsbury*.
16. *Estate of Andrews.*
17. *Estate of Scull.*
18. *Stone v. U.S.*, No. 3:06-cv-00259, No. Dis. of Cal.; and *Stone v. U.S.*, 100 AFTR 2d 2007-5512 (August 10, 2007).
19. The Art Advisory Panel is a panel of 22 outside art experts to whom the IRS submits taxpayer valuations of works of art. The panel classifies the art valuation as "justified, questionable, or clearly unjustified." According to Ralph E. Lerner/Judith Bresler in their book, Art Law (The Guide for Collectors, Investors, Dealers, and Artists), (2005), Volume II, Chapter 14, page 1151, "The report issued by the art panel is supposed to be only advisory. However, for all practical purposes, the local IRS district offices have been considering the valuation reports to be mandatory and binding on them."
20. The fourth approach focused on transactions in two secondary market partnerships holding rare coins and antiquities. The judge in *Stone* did not comment on this approach.
21. *Stone v. U.S.*, 100 AFTR 2d 2007-5512 (August 10, 2007).
22. *Supra* at note 11.
23. No. 219-96, 220-96, 221-96 (February 12, 1998).
24. *Estate of Forbes*, T.C. Memo. 2001-72 (March 23, 2001).
25. *Estate of Baird*, T.C. Memo. 2001-258 (September 28, 2001).
26. T.C. Memo. 1993-526 (November 16, 1993).
27. T.C. Memo. 1998-59 (February 12, 1998).
28. *Estate of Scull*, T.C. Memo. 1994-211 (May 12, 1994).
29. T.C. Memo. 2001-258 (September 28, 2001).
30. *Barge v. Commissioner*, T.C. Memo. 1997-188 (April 2, 1997).
31. *Estate of Baird*, T.C. Memo. 2001-258 (September 28, 2001).
32. *Estate of Stevens*, T.C. Memo. 2000-53 (February 18, 2000): Also *see Estate of Williams, T*.C. Memo. 1998-59 (February 12, 1998).
33. Generally restricted stock is the stock of a publicly traded company that has not been registered with the Securities and Exchange Commission for resale and is restricted from resale under Rule 144.
34. The FMV Restricted Stock Study is sold through Business Valuation Resources and can be obtained at http://www.bvmarketdata.com.
35. These involve partnerships that have registered with the Securities and Exchange Commission and, in exchange for limited financial filing requirements, are prevented from having transactions constituting over 10 percent of their interests in any given year and cannot sell interests on an organized exchange. Partnership Profiles, Inc. tracks and reports transactions in this limited secondary market.
36. Richard Bernstein, Karl Pinkernell, "A Simple Risk Reduction Tool: Time" (July 17, 2006).
37. Jianping Mei/Michael Moses, "Diversification Potential of the Fine Art Asset Class," PowerPoint presentation to Lehman Brothers (October 2, 2007).
38. From $8,969 in 1990 to $3,765 in 1998. Interestingly, the top 10 percent of Modern European paintings went from $5,790 in 1990 to $8,984 in 1998, an increase of 55 percent.
39. From $2,590.54 in January of 1990 to $9,181.43 in December of 1998.
40. Elin Lake Ewald, ASA, "Viewpoint: Determining the Fair Market Value of Fractional Interests in Works of Art," *Personal Property Journal*, Winter 1995, pp. 16–20.
41. In the study, Ms. Ewald also interviewed collectors. However, the collectors generally would not entertain a purchase of an undivided interest. Of the two collectors that did mention a price, one was at a 50 percent discount and the other at a 90 percent discount. In negotiations with the IRS, Ms. Ewald reports that the estate settled at a 25 percent discount.
42. However, extreme interests such as a 99 percent interest should not expect to achieve full undivided interest discounts.

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Foreign Corporations Owned by U.S. Persons

By G. Warren Whitaker

A basic rule of U.S. income taxation is that all U.S. corporations are subject to U.S. income tax on their world-wide income. Foreign corporations, on the other hand, are only subject to U.S. income tax on income from U.S. sources.[1]

U.S. taxpayers (citizens and residents) who know these rules and little else may ask "Why can't I transfer all of my cash into a foreign corporation, have that corporation invest in assets that earn non-U.S. source income and not pay U.S. income tax until the corporation pays me a dividend 20 years later?" While this tax deferral technique may be available for people in some other countries, the U.S. foreclosed it many years ago. This article will discuss two "anti-deferral" regimes: the Controlled Foreign Corporation rules and the Passive Foreign Investment Company rules. (A third set of rules which formerly applied, the Foreign Personal Holding Company rules, was repealed in 2004.)

These rules are extremely complex and this article is meant to be an introduction for those not familiar with them.

Controlled Foreign Corporations

It should be noted first that the Controlled Foreign Corporation (hereinafter "CFC") rules only apply to foreign **corporations**. A foreign entity that is recognized for U.S. tax purposes as a partnership or a pass-through entity, either *per se* or because it has filed a "check the box" election with the IRS to be so treated, is not subject to the CFC rules. Of course, if such an election is made, there will no deferral of income inside the entity, and income will instead be treated as passing through to the underlying owner or owners of the entity. In addition, a foreign corporation protects foreign shareholders against U.S. estate tax on U.S. situs assets held inside the corporation, while a foreign entity that is treated as a partnership or pass-through entity is generally not considered to offer such protection.

A foreign corporation is a CFC if more than 50% of its voting power or more than 50% of the value of its assets is held by "large U.S. shareholders."[2] For this purpose, "large U.S. shareholders" are persons who each own at least 10% of the voting power of all voting classes of stock.[3]

For ownership purposes, family attribution rules apply.[4] The shareholder is considered to own all shares of voting stock that are owned, directly or indirectly, by that shareholder's spouse, children, grandchildren, and parents. There is no attribution from siblings. In addition, if any of these relatives is a non-resident alien of the U.S., shares that they own directly or indirectly will not be included for attribution purposes.

If the corporation is a CFC, all large U.S. shareholders must report and pay tax annually on their proportionate shares of the corporation's "Subpart F income."[5] Subpart F income includes all investment income, such as dividends, interest, royalties and rents. It also includes some other types of income, but excludes most income from the active operation of a trade or business. Each shareholder is only taxed on his share of Subpart F income based on the shares that he or she owns directly or indirectly, and not on shares attributed to him or her by reason of relation to other family members.

All Subpart F income is taxed on an annual basis directly to the underlying shareholder at ordinary income rates of up to 35%. There are no lower rates for qualified dividends or capital gains.

Gain on the sale of a CFC is recognized as ordinary income. However, the shareholder's basis is increased for prior Subpart F income that has been recognized by the shareholder during the existence of the corporation prior to the sale.

Income other than Subpart F income is not taxed by the owner until it is paid out as a dividend. At that point, earnings and profits are computed after reduction for prior Subpart F income. Therefore, there is an advantage to a U.S. person owning a foreign corporation if that corporation is engaged in a trade or business outside the United States. In this case, profits from business (assuming they are not Subpart F income) will not be subject to U.S. tax and until they are paid to the U.S. in foreign dividends. However, if the profits are not reinvested in the business but instead are held in investments that produce passive income, that passive income will be Subpart F income and will be taxed currently.

As noted above, the U.S. shareholders are taxed on Subpart F income in proportion to their interests in CFCs that they own directly or indirectly. I.R.C. § 958(a)(2) provides that shares of a foreign corporation that are owned by another foreign corporation, foreign partnership, foreign trust or foreign estate are owned "proportionately" by its shareholders, partners or beneficiaries. This provision of the Code was obviously written by someone who was not familiar with trusts.

How does one determine who the "proportionate" owners of a discretionary trust are? The Regulations apply to a "facts and circumstances" test, which is not particularly enlightening.

The single example in the Regulations describes a trust which provides that one-third of its income is to be paid to or accumulated for a U.S. beneficiary, and that his share of trust principal and accumulated income is to be paid out to him on a stated date. Under these circumstances the beneficiary is treated as indirectly owning one-third of the shares of the CFC which is owned by the trust.

This example has two problems. First, it describes a trust that is very unlikely to be encountered in real life. In fact, most foreign trusts will have multiple discretionary beneficiaries and will continue for an indefinite term rather than paying out all assets to beneficiaries on a stated date.

Second, it ignores the requirement that U.S. persons have 10% or more of the voting power of the trust to be considered "large U.S. shareholders." If the trust has an independent foreign trustee, U.S. persons may not have any voting control over the shares held by the trust, and arguably will avoid the CFC category simply by reason of this voting power requirement not being met. However, the IRS may look through a structure that was deliberately designed to avoid giving U.S. persons direct voting power for purposes of the CFC requirements.

If we assume that the 10% voting power requirement is met, and that there are one or more "large U.S. shareholders," each of whom has more than 10% of the voting power, and who together control more than 50% of the voting power, the corporation is a CFC and therefore we must determine whether any U.S. beneficiaries of the trust indirectly are treated as owning interests in the CFC for purposes of Subpart F inclusion.

If the corporation is not a CFC because the voting test is not met, the foreign corporation may still be a PFIC if it has primarily passive income. However, the PFIC rules do not generally require annual recognition of Subpart F income by the direct or indirect owners, as the CFC rules do.

Note that the attribution rules for family members do not apply to indirect ownership for purposes of allocation of Subpart F income, but only to determination of whether a U.S. person is a 10% shareholder.

Various methods have been suggested to determine indirect ownership through a trust by analogy to the (now repealed) Foreign Personal Holding Company Rules. Among these are: actuarial tables applying mortality assumptions for beneficiaries; letters of wishes; identity and powers of the protectors; and looking at actual distribution history. Practitioners, faced with a dearth of authority in this field, generally believe that past and immediate future distribution patterns may be the best indicator, but at present it cannot be stated that there is a definitive method of making this determination.

Passive Foreign Investment Companies

International practitioners frequently encounter the non-U.S. citizen who has moved to the U.S. and is now a resident here for income tax purposes. When these people are told that they are subject to U.S. tax on their world-wide income, they will nod in understanding and state that they do not have any income from sources outside the United States. When pressed, these people will sometimes acknowledge that they own shares of a mutual fund based in Ireland, Jersey or the Cayman Islands, but will state that they received no taxable income from the fund since they are not making withdrawals or receiving any dividends. In addition, they do not receive a statement of the income of the fund which is also reported to the IRS, as is the case with their U.S. mutual funds. Therefore, these people assume they have no reportable income from their offshore funds.

With a moment's reflection, the reader will recognize that if this were actually the law, no rational U.S. person would ever invest in U.S. funds. Instead, U.S. taxpayers would invest in foreign mutual funds which allowed tax-free buildup of income and deferral of income tax until a withdrawal was made. This actually was to some extent the U.S. law until the passage of the Passive Foreign Investment Company rules in 1986, but it is no longer the case.

A PFIC is a non-U.S. corporation that meets the definition of "investment corporation" under IRS § 1297. (Once again, a foreign entity that is not treated as a corporation will never be a PFIC.) The corporation will be a PFIC if either (i) 75% of its gross income is passive, or (ii) 50% of its assets produce passive income.

There is no current income tax recognized by the U.S. owner of a PFIC until a distribution or disposition takes place (unless an election is made as described below).

When distributions are made from a PFIC, they are divided into "non-excess" and "excess" distributions. Excess distributions are generally those in excess of 125% of the three prior years' average distributions. Non-excess distributions will carry out their proportionate share of income of the PFIC, which will retain its character (for instance as qualified dividends or capital gains, which are subject to 15% tax). Excess distributions will be taxed at ordinary income rates, with

the highest rate prevailing for each year when the PFIC was in existence, together with an interest charge.

On sale of a PFIC, gain is treated as an excess distribution and therefore subject to income tax at the highest prevailing rate for each year the PFIC was in existence and an interest charge.

Either of two elections can be made to avoid PFIC status. The first is QEF election, which is an election by the U.S. owner to recognize and be taxed on the income of the PFIC each year. If such an election is made, capital gains and qualified dividend treatment for income realized inside the PFIC will be retained when recognized by the shareholder. However, in order to make this election the shareholder must obtain from the PFIC full information in U.S. tax format regarding all income and gains inside the PFIC. Very few foreign funds will be able to provide this information, particularly as to long and short term capital gains.

The second option is a "market to market" election by which the owner of the PFIC recognizes each year as ordinary income the increase in value of the PFIC. However, this election is only available for funds that are traded on a recognized securities exchange. Again, most foreign funds will not qualify.

Although the PFIC rules were aimed at foreign funds, and do not depend on percentage of U.S. ownership, they can also apply to foreign holding companies in a trust structure. However, if a corporation is both a CFC and a PFIC, the CFC rules will prevail.

Once a corporation qualifies as a PFIC, it will be a PFIC for as long as the U.S. person owns an interest in it, regardless of changes in income and assets from year to year.

While the PFIC rules were intended to punitively tax offshore accumulation of income in the same way as the accumulated income rules are intended to do for foreign non-grantor trusts, these two sets of rules were not carefully dovetailed. For example, it appears likely that non-excess distributions from a PFIC will be considered DNI to the foreign trusts, and that income excess distributions should **not** be distributed in the same year they will become part of UNI for that foreign trust.

Again, I.R.C. § 1298(a)(3) states that shares of a PFIC owned by an estate or a trust are owned "proportionately" by its beneficiaries. Regulations for PFICs, which were proposed in 1992 and have not been adopted, affirm that a "facts and circumstances" test will be applied in all determinations of indirect ownership of PFIC shares, but give no further guidance on questions of ownership of a PFIC by a foreign discretionary trust. One can only look to the treatment of CFCs and other rules; again, the same factors should apply.

Endnotes

1. A U.S. corporation is a corporation that has been incorporated in one of the 50 U.S. states (not including Puerto Rico, the Virgin Islands or other territories and commonwealths). There is no "mind and management test," and the location of meetings and identity of directors are not relevant.
2. I.R.C. § 857(a).
3. I.R.C. § 951(b).
4. I.R.C. § 958(b).
5. I.R.C. § 952..

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Have You DRA Proofed Your Power of Attorney?

By Anthony J. Enea

The enactment of the Deficit Reduction Act of 2005 ("DRA") on February 8, 2006, with its resulting five-year look-back period and onerous calculation of the period of ineligibility for non-exempt transfers of assets ("gifts"), has forced the Elder Law practitioner to consider alternative planning options. In the event these options were to be utilized by the agent acting under a General Durable Power of Attorney, it would be necessary that the Power of Attorney contain provisions explicitly permitting the agent to do so.

The powers to consider granting to the agent in order to permit the planning necessitated by the DRA include:

(a) The authority to enter into a "Personal Service Contract" or "Caregiver Agreement" on behalf of the principal with third parties, including the agent.

A specific acknowledgment should be included on behalf of the principal that the agent may be in a position of a conflict of interest and that the principal is expressly waiving any potential conflict. The acknowledgment and waiver of any conflict should also be included for all of the following proposed provisions for a power of attorney.

(b) The authority to purchase a life estate on behalf of the principal in the home of a third party, including the agent.

(c) The authority to make loans to third parties, including the agent, and to accept a DRA compliant promissory note as security for such a loan.

(d) The authority to purchase and/or enter into an annuity contract that is compliant with the DRA, with third parties, including the agent.

(e) The authority to create and fund, with the principal's assets, a Grantor Retained Annuity Trust ("GRAT") that is DRA compliant.

(f) The authority to create and fund, with the principal's assets, an Irrevocable Income Only Trust a/k/a "Medicaid Qualifying Trust" on behalf of the principal with the agent and or a third party acting as Grantor, Trustee or beneficiary thereof.

(g) The authority to create and fund, with the principal's assets, a Revocable Living Trust with the agent and/or a third party acting as grantor, trustee or beneficiary thereof.

(h) The specific authority to purchase Series I and Series EE United States Savings Bonds because they are not considered an available resource for Medicaid eligibility during this initial holding period.

The foregoing list of powers the agent should have post-DRA is not intended to be all inclusive but rather to highlight some of the more important powers that the agent should possess. Of course, in granting any powers to the agent, the practitioner should bear in mind the decision of the Court of Appeals in *In re Ferrara* (7 N.Y.3d 244, 852 N.E.2d 138, 819 N.Y.S.2d 215) when drafting appropriate language for inclusion in the power of attorney.

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Ties to U.S. and Canada

By Michael W. Galligan, Jeffrey B. Kolodny and Rachel E. Small

The distinctive challenges associated with the taxation of bequests and lifetime gifts made by individuals with ties to both the United States and Canada arise from the fact that the United States has federal estate and gift taxes, while Canada has neither form of transfer tax. Instead, Canada imposes a federal income tax on 50 percent of the appreciation on property owned at death or given away during lifetime.

While the 1995 (Third) Protocol (the "Protocol") to the 1980 Canada-U.S. Income Tax Treaty (the "Treaty") smooths out many of the wrinkles created by these two different regimes of gift and inheritance taxation, taxpayers can still benefit from planning in order to minimize tax.

U.S. Overview

The United States imposes federal estate and gift taxes on the "gratuitous" transfer of property "wherever located" by U.S. citizens or domiciliaries ("U.S. persons"). The current estate and gift tax rates range from 18 percent to 45 percent, depending on the value of the property transferred. Many states also have state estate taxes and a few have state gift taxes.

U.S. persons are currently allowed a credit, sometimes called the unified credit, enabling them to pass up to $2 million free of estate tax, $1 million of which can be transferred by gift during lifetime. Absent treaty relief, estates of persons who are not U.S. citizens or domiciliaries ("non-U.S. persons") are entitled to a minuscule credit allowing them to transfer only $60,000 worth of U.S. property free of estate tax. There is no similar credit for non-U.S. persons as to U.S. gift taxes.

An unlimited gift and estate tax marital deduction is available, which allows transfers of property to a U.S. citizen spouse without incurring either tax. Although the marital deduction is not available for the transfer of property to a non-U.S. citizen spouse, gifts of up to $125,000 a year (indexed for inflation) can be made to a non-U.S. citizen spouse without incurring gift tax. An individual can also transfer property at death to a qualified domestic trust or QDOT for the benefit of a non-U.S. citizen surviving spouse without incurring an estate tax unless and until principal distributions are made to the spouse or the spouse dies.

The following assets are subject to U.S. estate tax if owned by non-U.S. persons at death: (1) real property located in the United States; (2) tangible property located in the United States; (3) shares of stock in U.S. corporations, including residential co-ops; (4) mutual funds organized in the United States; (5) cash deposits with U.S. brokers (but not with U.S. banks), including money market accounts with U.S. mutual funds and cash in U.S. safety deposit boxes; (6) debts of U.S. obligors other than certain bonds issued after July 18, 1984; and (7) cash value of life insurance policies on the life of a person other than the non-U.S. decedent issued by U.S. life insurance companies. (There is considerable uncertainty as to whether interests in partnerships and limited liability companies holding the assets described above are U.S. property.)

For U.S. gift tax purposes only real property and tangible property located in the United States are subject to gift tax if transferred by a non-U.S. person. Significantly, interests in non-U.S. corporations and other foreign entities that are treated as corporations for U.S. tax purposes are not considered U.S. property, either for estate or gift tax purposes.[1]

Canadian Overview

In 1971 Canada replaced its federal estate and gift tax system with a tax on capital gains linked to the Canadian income tax. Soon thereafter the provinces and territories followed suit. Events such as death or making a gift are "deemed dispositions" of property by Canadian residents and therefore subject to gains tax. Fifty percent of all of capital gains (net of capital losses) are included in the income of Canadian residents. Canadian income tax rates for individuals currently range from 15.5 percent to 29 percent. Tax on such gains may be deferred if a disposition is made to a Canadian resident spouse (including common law and same-sex spouses).

Canada generally imposes income tax on individuals who are "residents" of Canada. An individual will be deemed to be a Canadian resident if he or she is physically present in Canada for 183 days or more in a calendar year or if he or she is "ordinarily resident" in Canada, which could occur if a person has a habitual abode in Canada but is present for less than 183 days a year. Various other factors may be examined to determine an individual's residence for Canadian tax purposes.

U.S. persons who are not Canadian residents are subject to Canadian income tax on sales and deemed dispositions of certain types of taxable Canadian prop-

erty, such as real property located in Canada, interests in Canadian companies, partnerships, trusts or estates that derive their principal value from Canadian real property, and personal property forming part of the business property of a permanent establishment resident in Canada ("Taxable Canadian Property").

Taxation Upon Death

Part 1: U.S. Persons Who Die Owning Canadian Property. While the U.S. estate tax provides a credit against foreign death taxes paid, this credit is limited to death and inheritance taxes and does not include income taxes. Helpfully, the Treaty provides relief from potential double taxation by providing estate tax credits for Canadian gains taxes on death-related property dispositions. The Protocol provides that income tax paid to Canada on the deemed disposition of Taxable Canadian Property upon the death of a U.S. person, whether or not a Canadian resident, is treated as a foreign death tax and, therefore, the United States must give a credit against the U.S. estate taxes imposed on the Canadian property for income tax paid to Canada.

Canadian tax law also provides for a deferral of tax on property that is transferred to a Canadian surviving spouse or a spousal trust at death. In effect, if an individual bequeaths real property to a surviving spouse who is a resident of Canada, that property is treated as being disposed of at its cost basis, with no recognition of gain or loss at the time of the transfer. As a result, the recognition of gain or loss will be deferred until the earlier of the sale or deemed disposition of the property by the surviving spouse. When an individual owning Canadian property is a resident of the United States immediately before death, the Treaty (as amended by the Protocol) extends this deferral benefit by treating the U.S. resident surviving spouse as a resident of Canada.

Part 2: U.S. Citizens Who Die as Canadian Residents. When a U.S. citizen dies resident in Canada owning U.S. property, Canada is obligated under the Treaty to give a tax credit against the Canadian federal income tax imposed on the deemed disposition of the U.S. property for U.S. estate taxes. However, the amount of this credit is limited to the estate taxes that would have been payable to the United States if the individual were not a U.S. citizen. The concept appears to be that, between this Canadian credit for U.S. estate taxes on the U.S. property and the U.S. credit for Canadian tax on the Canadian property discussed in Part 1, double taxation should effectively be avoided. However, most provinces take the position that the Treaty does not apply to them and the credit may not offset their portion of the tax (which can be as high as one-half of the income tax assessment).

Part 3: Canadian Residents Who Are Not U.S. Citizens and Die Owning U.S. Property. The Treaty (as amended by the Protocol) provides significant benefits to non-U.S. citizen Canadian residents who die owning U.S. property. The Treaty provides that Canadian residents are entitled to a unified credit against U.S. federal estate tax equal to the greater of (i) the unified credit available to estates of non-U.S. persons, which is currently $60,000, and (ii) a pro-rated portion of the unified credit available to estates of U.S. persons based on the value that an individual's gross U.S. estate bears to the value of such individual's worldwide estate. This means that a Canadian resident will not be subject to federal estate tax if the value of his worldwide assets is less than the amount of the unified credit, which is currently $2 million.

The Treaty also provides that, instead of using a QDOT to obtain a marital deduction, the estate of a Canadian decedent can take advantage of a marital credit that is available for U.S. property transferred to a surviving non-U.S. citizen spouse who is either a Canadian or U.S. resident (or to a spousal trust for such person). The amount of this additional credit is limited to the smaller of (i) the amount of the unified credit discussed in the previous paragraph allowable to non-U.S. citizen Canadian residents who die owning U.S. property, and (ii) the amount of additional estate tax that would otherwise be imposed on the property left to the spouse, if such property were subject to U.S. estate tax.

When U.S. federal estate tax is imposed on the estate of a Canadian decedent owning U.S. property, the Treaty provides a credit against any Canadian federal income tax for the U.S. estate tax paid on the U.S. property equal to the smaller of the two taxes. This credit will be useful in situations where the value of the U.S. property is significantly greater than its cost basis immediately prior to the death of the Canadian resident. For most Canadian residents in such a situation, however, there may still be some double taxation because the U.S. estate tax may not offset the provincial component of the Canadian gains tax.

Historically, many Canadian residents who owned U.S. property planned to avoid U.S. estate tax by holding the U.S. property through a Canadian holding company. Canadian law, however, imposes a substantial disincentive to such a strategy by imputing income to the shareholder for the use of property owned by the corporation. An exemption from this treatment for so-called "single-purpose corporations" was abolished in 2005 on the theory that the Protocol eliminated the danger that U.S. property owned by Canadian residents would be subject to double death taxes. However, this Canadian Revenue ruling ignored the fact that, even with the benefit under the Protocol of the credit for U.S. estate tax against the Canadian capital gains tax, the estate of a Canadian resident might be paying a net additional U.S. tax of as much as 30 percent of the value of

the U.S. property for the privilege of owning property in the United States instead of in Canada. Canada does not have limited liability companies, which are generally untested as barriers to U.S. estate tax on property owned by non-U.S. persons anyway. Alternative strategies that might be considered include the use of nonrecourse debt, life insurance and possibly acquiring U.S. property through partnerships.

Part 4: Canadian Citizens Who Die Resident in the United States. A Canadian citizen will be subject to worldwide U.S. estate tax if he is treated as a domiciliary of the United States at the time of his death. Since Canada taxes income based on residence, such a Canadian citizen will be exempt from worldwide Canadian income tax on the deemed disposition of assets at death because this tax applies on a worldwide basis only to residents of Canada. However, this individual will still be subject to Canadian income tax on the disposition of any Taxable Canadian Property, subject to the credits and deductions of the Treaty.

Taxation of Gifts

The United States has no statutory credit for foreign gift taxes. Therefore, while gifts of real property and tangible property located in the United States made by Canadian residents who are non-U.S. persons are subject to both Canadian income tax and U.S. gift tax, there is no offsetting U.S. tax credit. Similarly, a gift of Taxable Canadian Property by a U.S. person will be subject to both U.S. gift tax and Canadian income tax on the deemed disposition without any relief from double taxation. To make matters worse, the donee will have a "carry over" tax basis in the gifted property for U.S. income tax purposes, although a Treaty election may be available to treat this disposition as a simultaneous taxable event for U.S. purposes.

One solution to this problem for Canadian residents is to structure gifts so that they are not gifts of U.S. property. For example, if real property located in the United States is owned by a Canadian holding company, subject to the concerns discussed above in Part 3, the gift of the shares would not be subject to U.S. gift tax. With respect to a U.S. person, if a gift must be made of Taxable Canadian Property, it would be more efficient to make a gift of property with little or no appreciation to minimize the Canadian income tax liability with respect to the deemed disposition.

Charitable Contributions

Absent treaty relief, no U.S. income tax deductions are available for contributions made by U.S. persons to foreign charities. A similar limitation is imposed under the Canadian income tax law. In addition, in many cases, U.S. gift or estate tax deductions are not available for gifts or bequests made by U.S. persons to foreign charities unless the foreign charity is organized and operated exclusively for religious, charitable, scientific, literary or educational purposes and would not be disqualified for tax exemption under U.S. tax law.[2]

Subject to certain limitations, the Treaty allows U.S. persons to receive U.S. income and estate tax deductions for contributions and bequests made to Canadian charities and allows Canadian residents to receive income tax credits for contributions and bequests made to U.S. charities. The Treaty also permits a full U.S. estate tax deduction for U.S. property that is specifically devised to Canadian public charities.

Endnotes

1. For more details on planning, see Michael W. Galligan, "Buying USA: Ways of Minimizing U.S. Transfer Taxes on U.S. Property Interests of Non-U.S. Persons," STEP USA, June 2007.
2. For more details, see Michael W. Galligan, "International Charitable Giving and Planning Under U.S. Tax Law," Tax Management Estates, Gifts and Trusts Journal, Vol. 29, No. 03, May 13, 2004.

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Tax Incentives for Land Conservation Easements

By Bonnie McGuire Jones

While trusts and estates attorneys, along with many charitable organizations, focused on other opportunities for charitable giving under the Pension Protection Act (PPA)[1] that became law on August 17, 2006, the PPA brought significantly increased charitable income tax deductions and longer carry-forward periods for landowners who placed conservation easements on their real property between January 1, 2006 and December 31, 2007.

On January 31, 2007 Senator Max Baucus (D-MT) introduced a bill that would make the expanded tax incentives for conservation easement donations under the PPA permanent and on March 19, 2007, Representative Mike Thompson (D-CA) introduced a companion bill in the House.[2] After a number of months in the Senate Finance Committee, Senator Baucus' bill received approval when the "Habitat and Land Conservation Act of 2007" passed the Senate Finance Committee by unanimous voice vote on September 21, 2007.[3] The Act includes the permanent extension of the conservation easement incentives from Senator Baucus' original bill. At the time of writing this article, the Act has been referred to the full Senate for consideration but has not yet been scheduled for a Senate vote. Senator Thompson's companion bill remains in the House Ways and Means Committee. If this legislation is passed by the full Congress and signed by the President, the favorable rules on charitable deductions for conservation easements will not sunset on December 31, 2007. These rules will continue to provide individuals whose intent is to preserve real property with environmental, scenic or historic value, to limit suburban sprawl, and to protect agriculturally suitable land and timberland, with much to their liking.

Trusts and estates attorneys rather than real estate attorneys are typically the legal advisors consulted for charitable gift planning and design. For trusts and estates attorneys who feel out of their field when considering conservation easements, this article will provide (1) an introduction to conservation easements, (2) the greatly expanded charitable deductions they generate until December 31, 2007, which could become permanent if the proposed legislation becomes law, (3) New York State's separate conservation easement tax incentives, and (4) the mechanics and monitoring of conservation easements.

What Is a Conservation Easement?

A conservation easement is a permanent deed restriction on development rights, authorized by state law, that runs with the land.[4] With a conservation easement, a landowner enters into a binding agreement with a qualified not-for-profit land conservation organization or governmental unit to define the terms of the development and usage restrictions. The land conservation organization or governmental unit then holds, monitors and initiates enforcement of the terms of the easement, if necessary.

While a landowner can continue to live on the land and use it for farming and timber, if applicable, the effect of the easement is to protect the land from prohibited uses and development. Landowners, individuals as well as family limited partnerships, limited liability companies, and some types of corporations, are entitled to a federal charitable income tax deduction for placing a conservation easement on their real property. The value of the charitable deduction is generally equal to the difference between the land's value before the easement and its value after the placement of the permanent restrictions on development and usage rights.

In addition to donations of conservation easements, a conservation easement can also be conveyed by a sale, sale at a bargain price, as part of a like-kind exchange (I.R.C. § 1035), or donated or sold by one's estate.

Conservation Easement Incentives Under the PPA

Prior to the enactment of the PPA (and after December 31, 2007 if the favorable PPA provisions are not extended), owners of appreciated property could deduct the value of the donated conservation easement, up to 30% of their adjusted gross income (AGI) in the year the easement is put in place, with 5 years to carry forward any unused deduction.[5] Under the PPA provisions, landowners who established conservation easements between January 1, 2006 and December 31, 2007 could deduct up to 50% of their AGI. Qualifying farmers and ranchers who earn at least one-half of their income from the use of their land can deduct up to 100% of their AGI.[6] In addition, any unused charitable deduction can be carried forward for 15 years after the year when the conservation easement is created.[7]

Conservation easements can also create other tax benefits, such as reducing estate taxes, since real property subject to a restrictive easement is worth less than real property with full development and usage rights. In addition, some states, like New York, allow conservation easements to reduce annual real property taxes.

New York State's Conservation Easement Tax Credit

New York State was the first in the nation to enact a tax credit for conservation easements. New York State's Conservation Easement Tax Credit (CETC) provides that for tax years beginning in 2006, any New York State landowner who owns land restricted by a conservation easement will be entitled to an annual refund of 25% of the property taxes paid on the restricted land of up to $5,000 per year.[8] The CETC is available to owners of all easement-restricted land, regardless of when the easement was created, so long as the easement was wholly or partially donated to a public or not-for-profit conservation organization and so long as the easement is registered with the New York State Department of Environmental Conservation.[9] The CETC is a refundable credit, which means that if the credit exceeds the landowner's New York State income tax liability, the landowner will be entitled to a refund.

In addition, New York taxpayers are entitled to the same charitable deductions for state income tax purposes as they are for federal income tax purposes.

Mechanics and Monitoring of Conservation Easements

A conservation easement can be created for any of the following purposes: (1) preservation of open space, including farmland and forest land; (2) preservation of land for recreation use by or the education of the general public; (3) preservation of a natural habitat; or (4) preservation of historically important land or a certified historic structure.[10] Once the easement has been conveyed by deed, the owner continues to use the property and retains the rights to sell, rent, devise and donate the property, subject to the restrictions of the customized conservation easement.

The restrictions imposed by a conservation easement can include prohibiting or limiting subdivision of the land; prohibiting or limiting new structures and modifications to existing structures, roads and trails; protecting scenic views, watersheds, agriculturally suitable land or timberland; and full prohibitions against mining. Conservation easements can vary greatly. Audits by the tax authorities and ultimate review by the courts will determine if the value of the charitable deduction given to the landowner who places an easement on the property is commensurate with the degree of protection the easement provides.

In the event of noncompliance with the easement restrictions, the monitoring organizations are obligated to report the non-compliant activity to designated governmental agencies or departments and to take legal steps to enforce the restrictions. Courts can issue orders that can be enforced by local, state and federal law enforcement authorities. Fines can be levied and noncompliance can be reported to the IRS and to state tax authorities, which may generate audits of the income tax deductions taken by the landowners. Concern over inconsistencies in the valuation of easements and the enforcement of noncompliance with the easement restrictions caused Congress to tighten the requirements for facade easements of historic buildings and to predict heightened IRS scrutiny in exchange for the more generous charitable deductions.[11]

Crucial to the availability of this type of charitable deduction, and to the benefit received by the public from conservation easements, is the land conservation organization or governmental unit that holds the donated easement. In New York State both the Department of Environmental Conservation and the Department of Agriculture and Markets are authorized to hold conservation easements. They, along with not-for-profit organizations such as the members of the national Land Trust Alliance (www.lta.org) and the American Farmland Trust (www.farmland.org) can help landowners determine if their property would qualify for conservation easements and hold the easements.

It can take several months to coordinate and accomplish the requirements necessary to qualify for the tax incentives for land conservation easements. First, the real property has to be appraised and may need to be surveyed. An attorney will be needed to draft the easement language and often to negotiate the terms of the easement with the qualified land conservation organization or governmental unit that will be holding the easement. Some land trusts require the landowner to donate a certain amount or a percentage of the value of the easement to endow the organization's monitoring of the easement. This "endowment" will also qualify for a charitable deduction.

Conclusion

Some landowners who had been considering conservation easements for some time found that the increased tax incentives available under the PPA caused them to undertake the time and expense of creating and donating the easements.[12] Others hope that the tax incentives will bring more visibility to the efforts of the land trusts, land stewardship organizations, and governmental entities that are trying to protect agriculturally suitable land and timberland, limit suburban sprawl, and preserve real property with environmental, scenic or historic value.

According to the Federal Reserve Board, in the fourth quarter of 2006, real estate comprised 32.9%

of the net worth of households in the United States.[13] One recent study projected that the aggregate intergenerational transfer of wealth in this country for the period 1998 to 2052 will total $41 trillion.[14] If this figure proves accruate, then appoximately $13.5 trillion of wealth transfer will involve real estate. These statistics, coupled with the possibility of permanent charitable deduction incentives for conservation easements, have motivated many landowners and their attorneys to re-evaluate the tax incentives associated with conservation easements.

Endnotes

1. Pension Protection Act of 2006 (hereinafter "PPA"), Pub. L. No. 109-280 (2006).
2. S. 469, 110th Cong. (2007); H.R. 1576, 110th Cong. (2007).
3. Press Release, Senate Committee on Finance, Finance Panel Votes to Protect Land, Endangered Species (September 21, 2007), *available at* http://finance.senate.gov/press/Bpress/2007press/prb092107b.pdf.
4. N.Y. Envtl. Conserv. Law §§ 49–0301–49-0311 (2006).
5. I.R.C. § 170(b)(1)(C)(ii) (2006, before enactment of the PPA).
6. P.P.A. § 1206(a)(1) (amending § 170(b) of the Internal Revenue Code).
7. *Id.*
8. N.Y. Tax Law § 606(kk) (2006) (defining tax credit for individuals); N.Y. Tax Law § 210(38) (defining tax credit for corporations).
9. N.Y. Tax Law § 606(kk)(2) (2006).
10. I.R.C. §170(h)(4)(A) (2006).
11. P.P.A. § 1213 (amending § 170(h) of the Internal Revenue Code).
12. Rachel Emma Silverman, *Tax Break with a View*, Wall St. J., Mar. 7, 2007, at D1.
13. Federal Reserve Board, "Balance Sheet of Households and Nonprofit Organizations," March 8, 2007 *available at* http://www.federalreserve.gov/releases/Z1/Current/z1r-5.pdf.
14. John J. Havens and Paul G. Schervish, "Why the $41 Trillion Wealth Transfer Estimate is Still Valid: A Review of Challenges and Comments," Journal of Gift Planning, Vol. 7, No. 1 (March 2003), available at http://www.bc.edu/research/cwp/meta-elements/pdf/41trillionreview.pdf.

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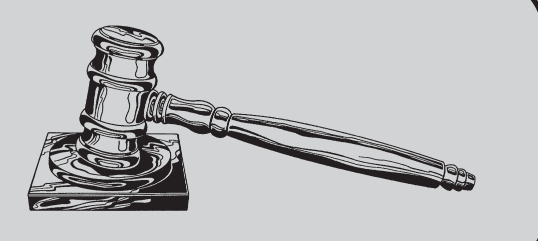
Recent New York State Decisions

By Ira Mark Bloom and William P. LaPiana



DISTRIBUTION

Non-Marital Children; Open and Notorious Acknowledgment Is Sufficient Proof of Paternity

Alleged maternal first cousins of the decedent objected to the Public Administrator's account. The objectants are the grandchildren of the putative father of decedent's mother. The Surrogate held that the law in effect at the decedent's death in 2002 applies and that under EPTL 4-1.2 decedent's mother's paternity must be established by clear and convincing evidence and her alleged father must have openly and notoriously acknowledged her as his child. After stating that the cases frequently discuss only open and notorious acknowledgment, the Surrogate concluded that "an open and notorious acknowledgment by all family members is in effect also used as proof of paternity." Finding that the evidence showed that decedent's mother and her half-siblings acknowledged their relationship to one another and that decedent and the marital descendants of her maternal grandfather also acknowledged their relationship, "it may be inferred that the maternal grandfather [who died in 1912] himself openly and notoriously acknowledged his paternity of the decedent's mother to his marital children." In addition there is no evidence that the maternal grandfather ever denied paternity of decedent's mother or that another person claimed to be decedent's maternal grandfather. The objectants are therefore distributees of the decedent. *In re Marks*, 16 Misc. 3d 334, 837 N.Y.S.2d 531 (Sur. Ct., Bronx Co. 2007)

FIDUCIARIES

Qualification; Professional Corporation Cannot Qualify as Executor

Testator nominated a professional corporation as executor. The sole shareholder argued that it could be defined as a natural person and therefore was eligible under SCPA 707. The Surrogate rejected the argument, stating that the shareholder "has elected to shield himself from individual liability by operating as a professional corporation rather than as an individual" and was bound by that choice. Letters were ordered issued to the successor nominated executor. *In re Huntington*, 16 Misc. 3d 914, 839 N.Y.S.2d 909 (Sur. Ct., Onondaga Co. 2007)

MEDICAID

Eligibility; Joint and Survivor Annuity Not an Exempt Transfer to Spouse

The Appellate Division upheld dismissal of Medicaid applicant's appeal of determination that his creation of a 10-year joint and survivor annuity for himself and his wife was a disqualifying transfer because it was not for her sole benefit. The 91-year-old wife would receive benefits only if she survived her 88-year-old husband. Because her life expectancy was 4.4 years, the annuity did not provide benefits for her on an actuarially sound basis as the regulations require and it was therefore likely that the estate of the last to die would receive some of the payments. Finally it was not irrational to follow applicable statute, regulations, and guidelines to value the amount received by the husband by using a single life annuity table. *Williams v. Weiner*, 42 A.D.3d 901, 839 N.Y.S.2d 654 (4th Dep't 2007)

PROCEEDINGS

Professional Responsibility; Attorney-Executor May Not Represent Himself in His Fiduciary Capacity

Attorney-executor brought a discovery proceeding under SCPA 2103 alleging that the estate is entitled to almost $400,000 transferred by the decedent's attorney-in-fact under a power of attorney executed shortly before the decedent's death because the decedent lacked capacity to execute the power of attorney and the agency and the transfers were the result of fraud and undue influence. The respondent moved to disqualify the petitioner from representing himself on the grounds that the advocate-witness rule (22 N.Y.C.R.R. § 1200.211) forbids an attorney from appearing as an advocate in a proceeding in which the lawyer will be a witness. Documents annexed to the petition made it clear that the attorney-executor would be called to testify.

The Surrogate granted the respondent's motion. Although there is a strong policy to allow all persons, not only attorneys, to represent themselves, here the attorney would be representing the interests of the estate's beneficiaries. The policies behind the advocate-witness rule therefore must prevail and the attorney must be disqualified. *In re Estate of Walsh*, 17 Misc. 3d 407, 840 N.Y.S.2d 906 (Sur. Ct., Bronx Co. 2007)

TRUSTS

Construction; Posthumously Conceived Grandchildren of Creator Are Beneficiaries of Trust

Creator of lifetime trusts provided that on his death the trustees are to sprinkle principal among his issue during the lifetime of his wife, who survived him. His wife has a special testamentary power of appointment to appoint among his issue and certain other permissible objects, and in default of exercise the property is to be distributed to his issue. One of creator's two sons predeceased him by six months. Before the son died he arranged for the cryopreservation of a sample of his semen which was to be held subject to the directions of his wife. After his death his wife used the semen for in vitro fertilization of her ova and gave birth to two sons, the first three and a half years and the second five years after her husband's death. The trustees then made an application for advice and direction concerning the status of the posthumously conceived children. Neither the trustees nor anyone interested in the trust opposed the inclusion of the children as beneficiaries. In addition, the remaining semen had been destroyed by the time of the application.

Surrogate Roth started by noting that the only mention of posthumously conceived children in the New York statutes is a 2006 amendment to the pretermitted child statute, EPTL 5-3.2, which excludes such children from the application of the statute. That exclusion is designed to ensure certainty in determining who is interested in an estate and finality in distribution and in any event is not applicable to the trusts involved in this application.

In the absence of New York authority, the Surrogate turned to "less immediate sources for a reflection of the public's evolving attitude toward assisted reproduction. . . ." After examining existing state statutes, decisions from other jurisdictions, uniform laws, and the provisions of Restatement (Third) Property (Wills and Other Donative Transfers) § 14.8, the Surrogate concluded that the legislatures and courts have tried to balance the competing interests of certainty and finality in the administration of estates and the respect due the "human desire to have children." In the end Surrogate Roth decided that the reasoning of Restatement (Third) and New York cases and statutes dealing with children conceived by artificial insemination stand for the proposition that "if an individual considers a child to be his or her own, society through its laws should do so as well." The posthumously conceived children are part of their father's family for all purposes and they are beneficiaries of the trusts because the dispositive scheme of the trusts and a sympathetic reading of their terms show that the grantor intended "all members of his bloodline to receive their share." *In re Martin B*, 17 Misc. 3d 198, 841 N.Y.S.2d 207 (Sur. Ct., N.Y. Co. 2007)

WILLS

Construction; Language Giving Beneficiary Absolute Ownership with Property to Be Held by Fiduciary and Applied to Beneficiary's Support Until Age 25 Creates Trust

Decedent's will contained a facility of payment clause directing that if any property vested in "absolute ownership" in a person under age 25, the decedent's fiduciary is authorized to hold the property in a separate fund, invest and reinvest the property, apply income or principal for the care, support, maintenance, and education of the beneficiary until age 25 at which time accumulated income and remaining principal is to be distributed to the beneficiary. The Appellate Division reversed the Surrogate and held that the language created a trust. In spite of the language directing vesting, the language indicates that the testator intended to give legal title to a trustee with authority to invest and reinvest the property and to use the income and principal for the benefit of the will beneficiary until age 25. *In re Maliszewski*, 42 A.D.3d 737, 839 N.Y.S.2d 586 (3d Dep't 2007)

No-Contest Clause; Violation Results in Lack of Standing to Ask for Construction

Decedent's will provided that any beneficiary who "directly or indirectly" became involved in a proceeding "about the provisions of the Will" would lose any gift in the will and could not "otherwise be a beneficiary." Daughter unsuccessfully contested probate and then brought a construction proceeding. The Appellate Division affirmed the Surrogate's dismissal of the proceeding because the language of the no-contest clause showed a clear intent to disinherit any party objecting to probate. Daughter therefore could not be a distributee and thus had no standing to seek a construction of the will. *In re Bernstein*, 40 A.D.3d 1086, 837 N.Y.S.2d 228 (2d Dep't 2007)

No-Contest Clause; Deposition of Drafter of Prior Will Results in Forfeiture

Decedent's will contained both a general no-contest clause and one applicable expressly to his son, both of which referred to challenges to the will and to the decedent's revocable trust. The son carried on examinations of the nominated executor, the witnesses to the will, the drafting attorney, and an attorney who had drafted a prior will of the decedent. The purpose of the last examination was to determine whether the provisions of the prior will would give the son a financial incentive to object to the proffered will. Objections were not

filed and the will was admitted to probate. The executor then asked the Surrogate for a construction of the no-contest clause. While examination of most of the persons examined does not violate a no-contest clause under the provisions of EPTL 3-3.5(b)(3) and SCPA 1404(4), those provisions do not include the drafter of a prior will. The son's action was a challenge to the will and outside of the statutory safe harbor, violated both no-contest clauses and resulted in forfeiture of his interests in the probate estate and the trust property. *In re Singer*, 17 Misc. 3d 365, 841 N.Y.S.2d 212 (Sur. Ct., Kings Co. 2007)

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

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Case Notes— New York State Surrogate's and Supreme Court Decisions

By Ilene Sherwyn Cooper

Attorney-Client Privilege

In a proceeding to determine the validity of a claim, the petitioners moved for an order directing the estate executors to produce all documents, recordings and transcripts of telephone calls. The estate responded by contending that the items were protected by the attorney-client privilege and not discoverable. In response, the movants alleged that the presence and participation in the conferences and calls of a co-executor's spouse deprived the estate of a claim of privilege.

Citing *Stroh v. General Motors, Inc*., 213 A.D.2d 267 (1st Dep't 1995) and *In re Nigro*, N.Y.L.J., 10/5/04, p. 20, the court disagreed, finding that the co-executor's spouse served as her agent at the subject meetings and conference calls relative to what the court described as a very sizable estate of approximately $130 million.

With respect to the movants' request for communications between the executors and their attorneys in the presence of the estate accountants, the court held that communications between an attorney and client in the presence of an accountant as well as independent communications between the client and accountant are protected by the attorney-client privilege under certain circumstances. The court found, nevertheless, that while the executors made a plausible argument in support of the confidentiality of the records sought, they had simply done so in a footnote contained in their memorandum of law, rather than through an affidavit by a person with knowledge of the facts. Accordingly, given the sums at stake, the court granted the executors additional time to submit their arguments relative to this issue in proper form.

In re Estate of Sosnow, N.Y.L.J., 7/13/07, p. 23 (Sur. Ct., Nassau Co.)

Before the court was an application by the attorney for the petitioner in an underlying accounting proceeding for a protective order quashing a subpoena that had been issued to him by objectant's counsel. The subpoena requests the appearance of counsel at a deposition as well as the production thereat of various estate records. The movant claimed that the subpoena was improper, vague, sought disclosure of material protected by the attorney-client privilege, and was unnecessary as objectant's counsel had already examined the petitioner and had the opportunity at that time to obtain the disclosure sought.

Objectant's counsel argued that the provisions of CPLR 4502(a)(2)(A) require disclosure, and that in any event, upon the revocation of the petitioner's letter testamentary, the attorney-client relationship between the petitioner and counsel ceased.

The court held that objectant's reliance upon CPLR 4503(a)(2)(A) was misplaced in that the statute was actually intended to prevent access to privileged communications between the fiduciary of an estate and the fiduciary's counsel, despite the fact that a fiduciary relationship exists between the fiduciary and beneficiary of the estate. Moreover, the court opined that once the privilege attaches, it becomes permanent, and thus continues even after a fiduciary is removed.

Additionally, the court noted that because the attorney was a non-party witness, the objectant was required to show special circumstances for the disclosure sought other than by claiming relevancy. The court held that such circumstances exist when, for example, it is shown that the subpoenaed information cannot be obtained through another source. Based upon this criterion, the court found that the objectant failed to make the requisite showing of need and accordingly, the movant's motion to quash the subpoena was granted.

In re Estate of Darretta, N.Y.L.J., 7/23/07, p. 37 (Sur. Ct., Suffolk Co.) (Surr. Czygier)

Deed Vacated

Before the court was an action to vacate a deed to real property. The records revealed that the plaintiff and defendant had purchased a home together as tenants in common. A mortgage loan was provided to both parties, and the deed to the property was recorded. Thereafter, the plaintiff commenced work renovating the premises. While the materials were purchased by the defendant, the plaintiff did all the work attendant to the renovation without remuneration.

Approximately one year later, the defendant approached the plaintiff to discuss a refinance of the

property in order to obtain a lower interest rate on the mortgage. The defendant agreed, and thereafter, without reservation or question, signed his name to numerous documents, which he believed were in connection with the refinance arrangement. Unbeknownst to the plaintiff, within the documents was a deed conveying his one-half interest in the premises to the defendant. The defendant later changed the locks on the property.

The court opined that the burden of proof rested upon the plaintiff to demonstrate the existence of fraud or undue influence in order to vacate the deed. However, if a confidential relationship between the parties was proven, the burden would shift to the defendant to show that the conveyance at issue was bona fide and free from improprieties.

Based upon the testimony, the court held that there was a confidential relationship between the plaintiff and the defendant based upon a long-standing period of mutual trust. Further, the court held that the defendant had failed to satisfy her burden of proving that the deed was valid and freely entered into.

Accordingly, the deed was vacated and the plaintiff's interest in the subject property re-instated.

Campbell v. Ward, N.Y.L.J., 8/28/07, p. 28 (Supreme Ct., Suffolk Co.) (Spinner, J.)

Joint Accounts

The administratrix of the decedent's estate filed suit against the former spouse of the decedent for the recovery of funds held in joint name by the decedent and the defendant in two Citibank accounts.

The record revealed that in connection with their divorce, the decedent and the defendant entered into an agreement waiving any future claims in each other's property, and acknowledging a final division of their property. However, at the time of his death, the decedent had not removed the defendant's name as beneficiary of his life insurance policy, an IRA account, and the subject Citibank accounts. The court noted that as to the life insurance proceeds and IRA account, the Appellate Division held that because the waiver provisions of the agreement between the parties in connection with their divorce did not specifically mention these assets, they rightfully belonged to the defendant upon the decedent's death. However, the court found otherwise in regard to the Citibank accounts.

Specifically, the court found that the evidence established that it was not the decedent's intent to make a gift of the proceeds in these accounts to the defendant. In reaching this result, the court relied upon testimony and proof that demonstrated that the accounts were established by the decedent in order to conduct transactions while out of the country; that the waiver in the divorce agreement was sufficient to encompass these accounts; the apparent difficulty the decedent had in removing the defendant's name from the accounts since his divorce from the defendant took place in Poland; the fact that the decedent was ill at the time the accounts were created; and the decedent's exclusive use and funding of the accounts.

Storozynski v. Storozynski, N.Y.L.J., 6/12/07, p. 24 (Supreme Ct., Nassau Co.) (Lally, J.)

Leave to File Late Objections

In a contested probate proceeding, the court granted the movant leave to file objections to probate despite the fact that the time to file objections had expired. Upon the initial return date of citation, objections to probate had been filed by two other parties, but not the movant, albeit jurisdiction had been obtained over the movant. Thereafter, an earlier will of the deceased was filed with the court and supplemental citation issued. Prior to the return date of supplemental citation, the movant sought to file objections.

The court opined that the right to file objections is a substantial right that should not be lightly disregarded, particularly when the validity of a will is at issue. This is in keeping with the court's paramount duty to insure that the propounded instrument is indeed the last will of the decedent, and as such, to thoroughly evaluate any objections or potential objections.

In support of his application, the movant claimed that he never received a copy of the propounded instrument at his residence in Italy. However, once learning of the underlying proceeding, the record revealed that the movant retained counsel, who sought to file objections on his behalf, alleging lack of testamentary capacity, lack of due execution, fraud and undue influence. These objections were returned as untimely.

The petitioner claimed that the movant had failed to explain his seven-month delay in filing objections or to demonstrate the likelihood of success of his claims. In response, the movant submitted the transcript of a hearing concerning the appointment of an Article 81 guardian for the decedent wherein the court found, *inter alia*, that the decedent suffered from certain functional limitations that would cause him to be confused and disoriented at times, and impaired his ability to care for his personal and financial needs. Additionally, the record revealed that although the petitioner for probate was named as guardian of the decedent's person, she was removed as one of his attorneys-in-fact.

Based upon the foregoing, and in view of the fact that the litigated probate proceeding had just commenced, the court, in the exercise of discretion, granted the movant leave to file his objections to probate.

In re Estate of Foresto, N.Y.L.J., 7/23/07, p. 37 (Sur. Ct., Suffolk Co.) (Surr. Czygier)

* * *

In a pending probate and discovery proceeding, the court authorized late filing of objections to probate, but denied the movant's request to vacate his default in a discovery proceeding.

The record in the probate proceeding revealed that prior to the time for filing objections, after the completion of 1404 examinations, counsel for the movant sought to file objections to the issuance of letters testamentary to the petitioner, but not to the probate of the propounded will. These objections were returned, although they were served on petitioner's counsel. Thereafter, the objections were revised, served once again on petitioner's counsel, and submitted to the court for filing. They were returned at this point for being untimely.

In regard to the discovery proceeding, the record revealed that the movant was served by petitioner with an order to show cause for discovery that was returnable August 1, 2006. The matter was adjourned on that date to August 22, 2006. The movant was duly served in the proceeding but failed to appear or file a responsive pleading. Although movant claimed he submitted an affidavit in opposition to the order to show cause, no such affidavit was on file with the court.

In view of the foregoing, the court held that in the probate proceeding the movant had timely filed objections to probate, and served the same on petitioner's counsel, but that the objections had not been filed with the court for technical reasons related to the standing of some, albeit not all, of the parties. Given the court's duty to insure the validity of the will admitted to probate, in the exercise of discretion, the motion was granted.

On the other hand, with respect to the discovery proceeding, the court held that the movant had failed to provide a reasonable excuse for his default, and failed to establish that he would have a meritorious claim if he were permitted to answer. Accordingly, the movant's application to vacate his default in the discovery proceeding was denied.

In re Estate of McMullen, N.Y.L.J., 7/23/07, p. 38 (Sur. Ct., Suffolk Co.) (Surr. Czygier)

Revocation of Letters

The residuary legatees under the decedent's will instituted separate proceedings requesting, *inter alia*, that the letters testamentary issued to the named executor under the instrument be revoked. The record revealed that prior to his appointment as fiduciary, the named executor pled guilty in the United States District Court to one misdemeanor count of unlawfully receiving a portion of real estate settlement charges in violation of the Real Estate Settlement Practices Act. The Magistrate ordered the fiduciary to pay a fine and mandatory surcharge, but did not sentence him to any jail time or probation.

The court opined that pursuant to the provisions of SCPA 707, a person is ineligible to receive letters if he is convicted of a crime constituting a felony under New York law. The court held that the crime for which the fiduciary pled guilty had no New York counterpart and, thus, was not a crime in New York so as to justify the fiduciary's removal.

The court further opined that an individual may be found ineligible to serve as fiduciary if he does not possess the qualifications required by reason of dishonesty. To demonstrate dishonesty, it must be demonstrated that the nominated fiduciary has engaged in a pattern of financial wrongdoing that poses a genuine, serious risk to the proper administration of the estate. Within these parameters, the court concluded that the fiduciary's misdemeanor conviction, although related to financial matters, did not constitute dishonesty sufficient to disqualify him. In particular, the court noted that the misdemeanor at issue was victimless, that the fiduciary was not ordered to serve any jail time or probation, and was not directed to pay restitution.

Accordingly, the court dismissed the proceedings.

In re Estate of Anderson, N.Y.L.J., 7/10/07, p.23 (Sur. Ct., Dutchess Co.) (Surr. Pagones)

* * *

In a contested accounting proceeding, the court revoked the letters testamentary that had issued to the decedent's spouse based upon her concessions that she had commingled the assets of the estate with her own, that she no longer wanted to assume the daily management of the estate due to ill health and age, and that she had failed to maintain the estate books and records, as well as allegations that she had distributed estate property to a person who was a not a beneficiary under the will and had allowed estate property to be rented at below market rentals. Although the executrix disputed that she had undervalued the property rentals and offered to reimburse the estate for any improper distributions, the court concluded that her letters should be revoked.

With regard to the issue of the spouse's successor, the court held that the objectant's request to be appointed was premature as she was not the nominated successor fiduciary named in the decedent's will. Moreover, the court opined that even if the named suc-

cessor failed to qualify, the objectant might not be an appropriate successor given the hostility between her and the decedent's spouse, and the fact that her appointment could place her in a position of conflict with the estate by reason of her having to collect past due rents from herself.

In re Estate of Hargrow, N.Y.L.J., 8/7/07, p. 35 (Sur. Ct., Bronx Co.) (Surr. Holzman)

Turnover of Assets

In an action transferred from Supreme Court, the plaintiffs, the decedent's sons, sought a turnover of specific items of the decedent's personalty at death. The defendants moved to dismiss the complaint on the grounds that the plaintiffs lacked standing to bring the action.

The record revealed that the plaintiffs were the children of the decedent's first marriage. That marriage ended in divorce pursuant to an agreement which provided, *inter alia*, that the decedent would execute a Will that would leave one-half of his net estate to the children of the marriage. In a prior decision, the court determined "net estate" to mean one-half of the decedent's estate minus estate taxes, funeral expenses, debts and all other administration expenses. Further, the court determined that the parties had intended that only testamentary assets would be included in the property subject to the provision, and that the valuation of those assets would be ascertained upon a final accounting.

In granting the motion to dismiss, the court held that under the Fiduciary Powers Act, the fiduciary of an estate has the discretion to make a distribution to a beneficiary in cash or in kind. Moreover, a fiduciary is required to make a distribution in kind only when the will of the decedent so provides, or if all the beneficiaries of the estate have submitted an unequivocal direction to the fiduciary to do so.

Within this context, the court found that there was nothing in the record to support the plaintiffs' claim that they were entitled to the specific property in issue. The separation agreement entitled them to only one-half of the net estate, and as creditors, rather than beneficiaries of the estate, they were not entitled to a distribution in kind.

Accordingly, summary judgment was granted.

In re Estate of Taylor, N.Y.L.J., 7/9/07, p. 36 (Sur. Ct., Westchester Co.) (Surr. Scarpino).

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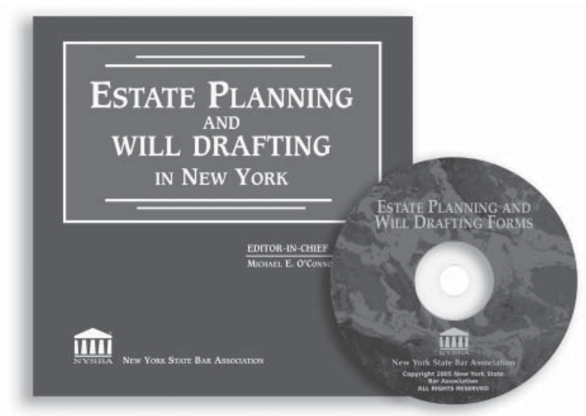

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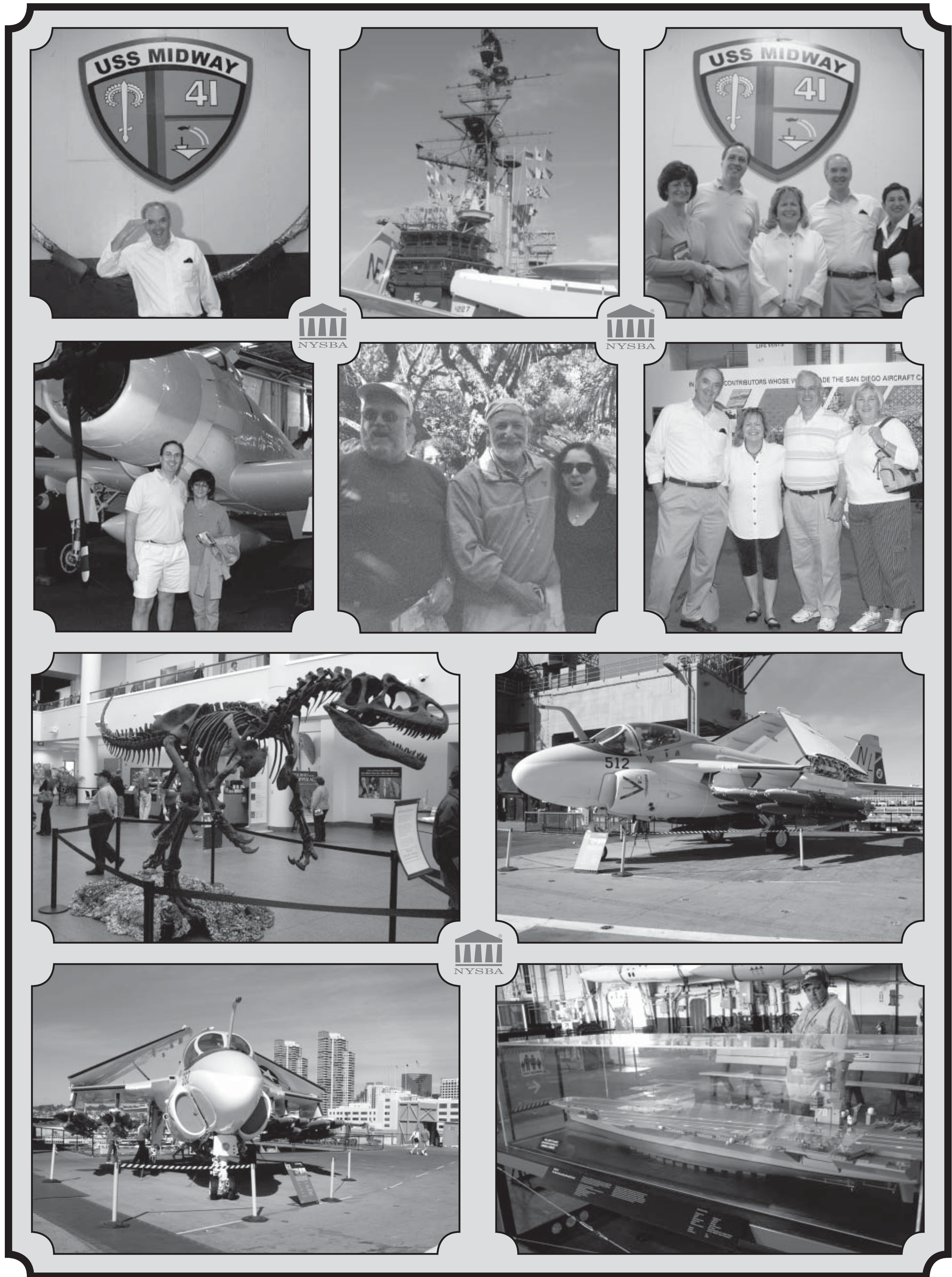
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