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Trusts and Estates Law Section Newsletter

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A Message from the Section Chair

Our Legislative Process

Carl T. Baker

Some of the most significant work our Section accomplishes is the improvement of the laws governing New York Trusts and Estates practice. Identifying a problem, drafting a solution, presenting it and obtaining approval—in the form of a new piece of legislation—is a key part of what we do.

But it ain't easy.

Drafting new legislation takes work, attention to detail and steady effort. Getting it enacted is a whole other story. It is a time-consuming, long-term process requiring patience and diligence. Let me explain by way of a real example.

Our Estate and Trust Administration Committee identified problems with the law regarding legacies that are not timely paid. The right of a beneficiary to interest on a delayed legacy was unclear and the process to obtain interest uncertain. The Committee drafted proposed legislation and brought it to the Executive Committee (EC) of our Section. The EC discussed the proposal, recommended changes and sent it back to the committee for further work (Note: I am actually making this up. I do not recall in any detail the conversations at the EC regarding this particular legislative proposal since it first came up for discussion in 2008 and became affirmative legislation in 2011. However, this is the normal process whenever a committee presents proposed legislation. And "discussed" may be a bit mild for a descriptor.)

Eventually, the Committee's refined proposal was presented, voted on and approved for affirmative legislation. The proposed legislation amends EPTL 11-1.5, EPTL 11-A-2.1, and SCPA 2102 to: (1) confirm that interest will be owed to a beneficiary if the legacy is not paid within 7 months of the fiduciary's receipt

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of letters; (2) tie the interest rate to be charged to the current economy; and (3) clarify that the payment will be an income tax deduction to the Estate. In short, the proposed legislation creates reasonable protections for beneficiaries while clarifying the rules for all of us who deal with estate settlements. Now, how do we make it law?

The first step involves the larger Bar Association as a whole. For any Section of the NYSBA to pursue legislative changes, the House of Delegates (HOD) must approve the legislation. The process of obtaining approval is essentially administrative, requiring timely posting and noticing of the proposed legislation to the larger Bar so that any other Section or group that may be affected by it will have time to consider the legislation and be able to express their concerns. Upon proper notice to all, this legislation was added to the HOD agenda and approved.

At the same time NYSBA approval is being pursued, experience has taught us that the first thing our intrepid legislators will want to know is who could possibly be against a proposal and why. In the world of Trusts and Estates matters there are several, natural stakeholders who must be "on board" if our legislative proposals are to become law. The first, and perhaps most compatible, is the Trusts, Estates and Surrogate's Courts Committee of the New York City Bar Association. Because of the size, experience and quality of that Association, and in particular that subcommittee, their support carries significant weight and their interests commonly align with ours. The combined input and expertise of both groups produces more thoughtful, quality legislation. And so, a "Memorandum in Support" was pursued and obtained from the City Bar.

Other groups that are often concerned with our affirmative proposals include the Surrogate's Association, the New York Banker's Association, and the Office of Court Administration. Depending on the proposal and who it impacts, our committees will work with any or all of these groups to respond to their concerns and to craft a bill they can support (or at least not oppose).

At this point, having crafted the legislation, having it fined tuned and approved by our EC, presenting it and getting it passed by the NYSBA House of Delegates, and lining up the support of necessary stakeholders (in the matter at hand, the OCA, the Bankers and the City Bar all support this legislation), an enormous number of volunteer hours (perhaps better known as lost billable hours) have been required and contributed by our members…but many more are yet needed.

Working with the NYSBA and their lobbyists, our Legislation and Governmental Relations Committee obtains sponsors for the legislation in the Assembly and Senate, and bill numbers are assigned (in this case, A01185 and S4952). In the early Spring, representatives of our Section head to Albany for "lobby day" to meet with the bill's sponsors in the Senate and Assembly, their staffs, and with representatives of the Governor's office, since his signature will eventually be required, to promote our initiatives in general, address questions, and provide information with the hope of easing the passage of the proposal into law.

And that is where our control and efforts cease and the experience and contacts of the NYSBA lobbyists, to push and seek support for passage, take over, and we, and they, are at the mercy of the vagaries of our legislative processes. Each Spring, with the end of our legislature's session, a flurry of sudden activity and bill passages occur—and we hope that our initiatives are included. The "Interest on Legacies" legislation was initially put forward but not approved in 2011, and in 2012, and now again in 2013. This fairly straightforward, non-controversial proposal, with the affirmative support of all key players, once again was not passed in the final rush of legislative enactments. Why not? No one seems to know. The workings of our legislature remain an enigma shrouded in a mystery. And so, this proposal will again be pursued in 2014, and the patience and diligence of our dedicated committee members will again be required and tested.

I offer this information to all of you for several purposes. First and foremost, out of respect for and to acknowledge the hard work and extraordinary efforts of our Committees and their members. Secondly, as a report on one aspect of our Section's efforts and processes. And lastly, to emphasize what is required for a relatively modest legislative change and proposal.

That last point provides context for an initiative that is currently under way: the complete reformation of our statutory Trust Code. A special committee of our Section has been charged with reviewing the Sixth Report of the EPTL-SCPA Advisory Committee—a report that recommended New York enact the Uniform Trust Code, "but with substantial variations."

This is a massive undertaking, addressing important and complex legislation, in which all of the above referenced stakeholders have strong and independent interests. We can only hope that when finally agreed to and readied for enactment, the legislative process will honor and respect the considered effort that will have been applied to this project.

Carl T. Baker

Editor's Message

This edition of our *Newsletter* contains articles pertinent to the estate planner, including topics such as tax planning and charitable giving, while also addressing issues of corporate dissolution that may be of particular interest to the litigators among us. Specifically, Austin W. Bramwell and Vanessa L. Kanaga provide a thorough explanation of the New York estate tax, and the effects of certain planning techniques, including gifting and portability. Portability is further analyzed by Philip J. Michaels and Brian G. Smith. Also on the topic of estate planning, Andrew S. Katzenberg explains the pros and cons of establishing a not-for-profit corporation as opposed to a charitable trust, including the varying liabilities of the corresponding directors and trustees. Finally, Gary Bashian discusses issues arising when estate beneficiaries become minority shareholders in a closely held family business, and the circumstances in which statutory and common law dissolution may be pursued, while Anita Rosenbloom and Eva Talel present an informative discussion about trust ownership of cooperative apartments.

We continue to urge Section members to participate in our *Newsletter*. CLE credits may be obtained. The deadline for submissions for our next edition is December 9, 2013.

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The Paradoxical Computation of New York Estate Tax*

By Austin W. Bramwell and Vanessa L. Kanaga

New York estate tax was supposed to be little more than an afterthought. Effective February 1, 2001, New York adopted a so-called "sop" or "pick up" tax equal to the maximum amount of the federal state death tax credit that had been permitted under Internal Revenue Code (IRC) § 2011.[1]

Under that credit, every dollar of estate tax paid to New York reduced the federal estate tax by a corresponding dollar. New York estate tax, therefore, did not increase an estate's overall estate tax burden.[2] As a result, many hoped that New York estate tax could safely be ignored in estate planning.

Alas, no sooner did New York's sop tax become effective than Congress enacted legislation to replace the state death tax credit with a state death tax deduction.[3] The deduction, if state death tax is paid, reduces the federal taxable estate but, unlike a credit, does not produce a dollar-for-dollar reduction in the amount of federal estate tax. An estate that pays federal estate tax, therefore, may need to pay an extra tax to New York.

Meanwhile, the federal estate tax exemption amount has more than quintupled even as the maximum New York estate tax exemption amount has remained frozen at $1 million. With the federal exemption already $5.25 million and scheduled to increase annually, very few New York estates will have any federal estate tax liability. However, many more will have to pay New York estate tax.

For all its increased salience, however, the New York estate tax is not well understood. Many attorneys, for example, overlook that adjusted taxable gifts,[4] although they may not save federal estate tax, are normally excluded from the New York estate tax base. Consequently, a New Yorker can achieve significant estate tax savings by making lifetime gifts. Indeed, as discussed below, even gifts made just prior to death can save a substantial amount of tax.

Paradoxically, however, although lifetime gifts save New York estate tax, they simultaneously reduce the maximum amount that can pass free of New York estate tax at death. Although the maximum New York exemption amount is $1 million,[5] the maximum amount that can pass free of New York estate tax may be less than $1 million if the decedent made lifetime gifts. In fact, as discussed below, the effective New York estate tax exemption amount may be as low as $100,000 if the decedent made $900,000 or more of adjusted taxable gifts.

This article corrects some common misconceptions regarding the computation of New York estate tax, and discusses certain planning implications of that computation. One such implication is that New Yorkers of even moderate wealth should consider making lifetime gifts, including "deathbed" gifts. Another is that a so-called "credit shelter trust" for the benefit of a surviving spouse, even if limited to the New York exemption amount, may be undesirable in many cases.

"Alas, no sooner did New York's sop tax become effective than Congress enacted legislation to replace the state death tax credit with a state death tax deduction."

Computation of New York Estate Tax: A Review

N.Y. Tax Law § 952 imposes an estate tax equal to the maximum federal state death tax credit under IRC § 2011. Although the state death tax credit was phased out and ultimately eliminated under the Economic Growth and Taxpayer Relief and Reconciliation Act of 2001 (EGTRRA), for purposes of N.Y. Tax Law article 26 (relating to estate tax), references to the IRC are to the IRC as amended through July 22, 1998 (the "pre-EGTRRA IRC").[6] Thus, unlike many "sop" taxes enacted in other states, the New York estate tax was not effectively eliminated by the abolition of the federal state death tax credit. Rather, the New York estate tax is equal to the "old" credit that was available just before IRC § 2011 was amended by EGTRRA.[7]

To understand the computation of New York estate tax, therefore, one must understand how the state death tax credit was calculated under the pre-EGTRRA IRC. Under pre-EGTRRA IRC § 2011, one began by subtracting $60,000 from the decedent's taxable estate. The result was called the "adjusted taxable estate." The next step was to compute a tentative credit using the schedule set forth in pre-EGTRRA IRC § 2011(b). The schedule is reprinted in Appendix A of this article. For example, if the taxable estate was $1 million (resulting in an adjusted taxable estate of $940,000), the tentative credit under pre-EGTRRA IRC § 2011(b) was $33,200.[8]

The computation of the credit did not end there. Under pre-EGTRRA IRC § 2011(f), the state death tax credit could not exceed the federal estate tax under

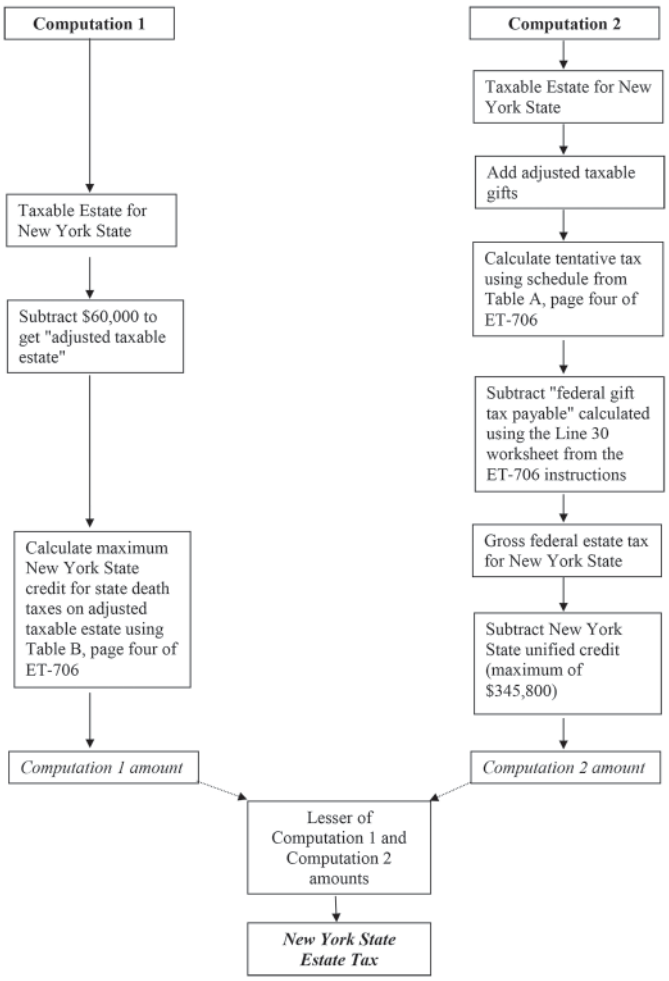
IRC § 2001(b), reduced by the unified credit. Thus, to derive the final amount of the credit, one had to calculate the "gross" federal estate tax (i.e., the tax before credits were subtracted) and then subtract the unified credit. The state death tax credit was only available if the tentative state death tax credit was less than the net federal estate tax.

In other words, pre-EGTRRA IRC §§ 2011(b) and 2011(f) divided the calculation of the state death tax credit into two separate computations, referred to herein as "Computation 1" and "Computation 2." Computation 1 is the tentative state death tax credit under pre-EGTRRA IRC § 2011(b). Computation 2 is the federal estate tax that would have been due under pre-EGTRRA IRC § 2001(b) after subtracting the unified credit. For purposes of the New York estate tax, N.Y. Tax Law § 951(a) stipulates that the unified credit is the amount that would be allowed if the applicable exclusion amount were $1 million. Under this definition, the New York unified credit is $345,800. This amount is subtracted from the hypothetical federal estate tax to obtain the result of Computation 2. New York estate tax is equal to the lesser of the Computation 1 and Computation 2 amounts.

The two computations are set forth in the New York State Estate Tax Return (ET-706) and corresponding instructions. Computation 2 happens to come first. On Line 29 of the ET-706, the tentative federal estate tax is calculated (at the 1998 rates) on the taxable estate for New York, plus adjusted taxable gifts. In accordance with pre-EGTRRA IRC § 2011(b)(2), the equivalent of a credit is then permitted on Line 30 for the federal gift tax that would have been payable on the decedent's taxable gifts, assuming a unified credit amount of $345,800. The New York unified credit ($345,800) is then subtracted from this tentative tax on Lines 32-35. The result is the Computation 2 amount, which is entered on line 35.

Computation 1 follows on line 36, which instructs the return preparer to calculate the maximum credit for state death taxes using Table B on page four of the return. Table B recapitulates the computation of the tentative state death tax credit under pre-EGTRRA IRC § 2011(b). If the maximum credit under Table B exceeds the amount on line 35, then the line 35 amount is entered on line 36 and also on line 1 of the ET-706. If, on the other hand, the maximum credit using Table B is less than the amount on line 35, then the maximum credit amount is entered on line 36 and again on line 1. With the exception of certain reductions for property located outside of New York State, the line 1 amount is the amount of New York estate tax due. Thus, to summarize, the New York estate tax equals the lesser of (1) the federal estate tax which would be due using 1998 rates and a unified credit of $345,800—i.e., the Computation 2 amount, and (2) the maximum credit for state death taxes under Table B—i.e., the Computation 1 amount.

The following flowchart illustrates the process for calculating New York estate tax:



How Gifts Save New York Estate Tax

Once the computation of New York estate tax is understood, it becomes clear that adjusted taxable gifts reduce the amount of New York estate tax that will be due at death. Suppose, for example, that a decedent dies with a taxable estate of $1.5 million having made no taxable gifts. In that case, the Computation 1 amount—i.e., the maximum state death tax credit under IRC § 2011(b)—will be $64,400. The Computation 2 amount—i.e., the hypothetical federal estate tax assuming a $1 million applicable exclusion amount—will be $210,000. Thus, the New York estate tax is $64,400, which is the lesser of the two amounts.

Table 1

Adjusted Taxable Gifts	Taxable Estate for New York State	**Computation 1**: Maximum State Death Tax Credit Under pre-EGTRRA IRC § 2011(b)	**Computation 2:** Hypothetical Federal Estate Tax Under Pre-EGTRRA Law Assuming a Federal Estate Tax Exemption of $1 million[9]	New York Estate Tax
$0	$5,000,000	$391,600	$2,045,000	$391,600
$1,000,000	$4,000,000	$280,400	$2,045,000	$280,400
$2,000,000	$3,000,000	$182,000	$1,610,000	$182,000
$3,000,000	$2,000,000	$99,600	$1,100,000	$99,600
$4,000,000	$1,000,000	$33,200	$1,045,000	$33,200
$4,900,000	$100,000	$0	$55,000	$0

Now suppose that the decedent gave away $500,000 during his or her lifetime in the form of adjusted taxable gifts and dies with a taxable estate of $1 million. The Computation 2 amount will be the same as before, i.e., $210,000. The Computation 1 amount, however, is now only $33,200. Thus, the New York estate tax is $33,200, or $31,200 less than the tax incurred if the decedent died with a taxable estate of $1.5 million. The $500,000 gift cuts the New York estate tax burden by nearly half.

There are essentially two reasons why, as the above example shows, adjusted taxable gifts save New York estate tax. First, adjusted taxable gifts are not included in the tax base under Computation 1. Rather, Computation 1 is based solely on the taxable estate. So long as Computation 1 results in a number that is lower than Computation 2, therefore, adjusted taxable gifts will reduce the amount of New York estate tax due.

Second, the Computation 1 amount is, in fact, normally less than the Computation 2 amount. After all, the federal government did not wish to shift 100% of its estate tax revenue to the states. On the contrary, the purpose of the state death tax credit was to shift some revenue to the states but keep the lion's share for the U.S. government. In other words, the tentative credit computed under pre-EGTRRA IRC § 2011(b) (Computation 1) was designed to be less than the federal estate tax due (Computation 2).

To illustrate, Table 1 (above) shows what happens if a New Yorker with $5 million of wealth gives away $0, $1 million, $2 million, $3 million, $4 million, or $4.9 million during lifetime via adjusted taxable gifts.

Note that there need not be any post-gift appreciation for the tax savings to be secured. Unlike in the case of the federal estate tax, adjusted taxable gifts are simply removed from the New York estate tax base under Computation 1.

The Effect of the New York Unified Credit

If the Computation 1 amount is normally less than the Computation 2 amount, and the New York estate tax is always the lesser of the two amounts, when will Computation 2 have any effect at all? The answer is that Computation 2 will be less than Computation 1 only if the decedent's taxable estate, plus adjusted taxable gifts, is between $100,000 and $1,093,785.30. In those situations, the Computation 1 amount (the maximum credit for state death taxes) will be greater than $0, while the Computation 2 amount (the hypothetical federal estate tax, reduced by the New York unified credit) will be $0 (or potentially greater than $0, if the taxable estate plus adjusted taxable gifts is between $1 million and $1,093,785.30, but still less than the Computation 1 amount). Thus, a taxpayer who never has more than $1 million of wealth will not save New York estate tax by making gifts. Regardless of whether he or she transfers wealth during lifetime or at death, the New York unified credit will ensure that the estate tax will always be $0 if he or she never had more than $1 million.

For a New Yorker with more than $1 million of wealth, by contrast, the New York unified credit turns out to be largely irrelevant. Because his or her wealth exceeds the maximum New York exemption amount, the Computation 2 amount will be greater than $0, regardless of whether the wealth is included in the taxable estate at death or added to the Computation 2 tax base as an adjusted taxable gift. The Computation 1 amount, however, will necessarily be less than the Computation 2 amount in nearly every case.[10] Thus, adjusted taxable gifts will still effectively reduce the amount of New York estate tax payable.

Deathbed Gifts

Even gifts made just prior to death can still save New York estate tax. It may be helpful to begin by reviewing why, by contrast, deathbed gifts do not generally save federal estate tax. There are essentially two reasons. First, lifetime taxable gifts, including those made before death, are added to the federal estate tax

base, either as adjusted taxable gifts or because they are included in the gross estate under one of the "string" sections of the IRC (i.e., IRC §§ 2035-42). Consequently, gifts made just before death will not save tax but will simply absorb more of the unified credit that is available to shield the taxable estate from tax.[11]

Second, any gift taxes paid on deathbed gifts are not removed from the federal estate tax base but added to the gross estate under IRC § 2035(b). That section requires inclusion in a decedent's gross estate of gift tax paid on gifts made within three years of death. Consequently, unless the donor survives three years from the date of the gift, his or her estate will pay estate tax on the gift taxes paid.

Neither of these reasons applies, however, in the case of New York estate tax, because of the way adjusted taxable gifts and gift taxes payable on deathbed gifts are factored into the computation of New York estate tax. As discussed, adjusted taxable gifts are not added to the Computation 1 tax base and therefore will normally escape New York estate tax. Unlike some states, New York does not currently impose estate tax on gifts made *causa mortis.* Nor does it have a "look-back" rule for gifts made within a certain period of time prior to death. Thus, as Computation 1 is normally less than Computation 2, adjusted taxable gifts, even if made just before death, reduce New York estate tax just as effectively as gifts made many years earlier.

Second, even though gift taxes payable on a deathbed gift are added to the taxable estate under IRC § 2035(b), the gift will still result in New York estate tax savings. Suppose, for example, that a decedent made a deathbed gift of $1 million and paid $400,000 of federal gift tax. The $400,000 will be added to the Computation 1 tax base and will increase the New York estate tax. However, the $1 million gift is not itself included in the Computation 1 tax base. Of the total $1.4 million, more than 70% escapes New York estate tax. At the highest New York estate tax bracket, the savings will be $160,000. Thus, even if a New Yorker pays federal gift tax on a deathbed gift, the gift can still save substantial New York estate tax.[12]

When Lifetime Gifts Do Not Save New York Estate Tax

In rare cases, even for a New Yorker with more than $1.1 million of wealth, an adjusted taxable gift will not produce tax savings. For example, suppose that a New York resident has $2 million and makes a lifetime gift of $1 million. By the time of the taxpayer's death, the property transferred by gift loses all of its value. The taxpayer dies with a taxable estate of $1 million and adjusted taxable gifts of $1 million. The New York estate tax is $33,200. Had the taxpayer retained the property and died with a $1 million taxable estate having made no taxable gifts, no New York estate tax would have been due.

Apart from that unusual circumstance, however, adjusted taxable gifts will almost always reduce New York estate tax if the decedent had more than $1 million of wealth.

How Lifetime Gifts Reduce the New York Exemption Amount

Perhaps counter-intuitively, although adjusted taxable gifts save New York estate tax, they also effectively reduce the amount that can pass free of New York estate tax at death. Technically, the New York unified credit is always $345,800. Unlike in the calculation of federal estate tax, however, the unified credit is not simply subtracted from the gross amount of New York estate tax. On the contrary, the New York unified credit is only subtracted in Computation 2 but plays no role in Computation 1. As adjusted taxable gifts are added to the tax base in Computation 2, they will absorb the unified credit, thereby reducing the size of the taxable estate that can pass free of tax under Computation 2.

Meanwhile, regardless of the amount of adjusted taxable gifts, a tax will still be generated under Computation 1 if the taxable estate is over $100,000. To illustrate, suppose that a New York resident makes $1 million in adjusted taxable gifts and dies with a taxable estate of $500,000. Although the taxable estate is less than $1 million, the sum of the taxable estate and adjusted taxable gifts is still $1.5 million. Thus, after subtracting the unified credit, Computation 2 produces a tentative tax of $210,000. Computation 1, meanwhile, produces a tentative tax of $10,800. The unified credit is not subtracted from the Computation 1 amount. Thus, $10,800 New York estate tax will be due.[13] The tax is significantly less than the $64,400 that would have been due if the decedent made no gifts and died with a taxable estate of $1.5 million. Nevertheless, the tax is not reduced to $0.

As the example shows, it is very difficult for a New Yorker with more than $1 million of wealth to avoid New York estate tax entirely (other than, of course, by transferring property in a form that qualifies for the estate tax marital or charitable deductions). The threshold above which Computation 1 produces a tentative tax is only $100,000. Consequently, so long as the sum of adjusted taxable gifts and the taxable estate exceeds $1 million, and thereby fully absorbs the New York unified credit under Computation 2, there will usually be some tax due under Computation 1.

The following table sets forth the largest taxable estate that will produce a New York estate tax of $0 assuming a given amount of total adjusted taxable gifts:

Table 2

If the decedent's total adjusted taxable gifts are:	Then the largest taxable estate that will not produce a New York estate tax is:
$0	$1 million
$100,000	$900,000
$200,000	$800,000
$300,000	$700,000
$400,000	$600,000
$500,000	$500,000
$600,000	$400,000
$700,000	$300,000
$800,000	$200,000
$900,000	$100,000
More than $900,000	$100,000

As Table 2 shows, as taxable gifts increase, the size of the taxable estate that can pass free of New York estate tax decreases. Once adjusted taxable gifts reach $900,000, the New York estate tax exemption amount is essentially reduced to $100,000 (but will not drop below $100,000, as that is the threshold at which the credit for state death tax begins to apply). If the taxpayer makes sufficient lifetime gifts to reduce his or her estate to $100,000 or less, New York estate tax will always be $0.

Planning Implications

1. Make Lifetime Gifts to Save New York Estate Tax

As discussed, a New York resident can significantly reduce his or her New York estate tax burden by making lifetime gifts. Even New York residents whose wealth does not exceed the federal estate tax exemption amount should consider making lifetime gifts, including gifts made just prior to death, in order to reduce their New York estate tax liability. The savings are enhanced if the property transferred by gift appreciates in value before the donor's death. However, adjusted taxable gifts can reduce New York estate tax even with no post-gift appreciation.

Making a gift in order to pass on future appreciation may be desirable if an individual's wealth does not currently exceed the maximum $1 million New York estate tax exemption amount. In that case, the value of his or her wealth for New York estate tax purposes can effectively be "frozen" by making gifts of assets likely to appreciate in value. If the individual's taxable estate plus adjusted taxable gifts is less than $1 million, New York estate tax will be avoided, even if the assets transferred during lifetime have appreciated significantly by the time of his or her death.

As is always the case when planning with lifetime gifts, however, consideration should be given to the fact that property transferred by lifetime gift does not receive the "step up" in basis applicable to property included in the decedent's gross estate.[14] The loss of a change in basis at death may cause significant capital gains tax if the appreciated property is later sold by the donee. That said, even accounting for the loss of the step up in basis, it will in many cases still be advantageous to make lifetime gifts. The income tax costs of lifetime gifts should always factor into the analysis of whether to make lifetime gifts and in identifying which assets to transfer.

2. Using Portability to Save New York Estate Tax

As the authors have noted elsewhere,[15] the new "portability" provisions of the IRC, which permit a surviving spouse to inherit the unused federal estate tax exemption of his or her predeceased spouse (the "first decedent"), enable married New Yorkers to achieve two objectives that had previously been seen (by many) as irreconcilable: deferring the payment of both federal and New York estate tax until the surviving spouse's death yet preserving the unused federal estate tax exemption of the first decedent.[16] For example, the first decedent may leave his or her entire estate to the surviving spouse in a form that qualifies for the estate tax marital deduction. Neither federal nor New York estate tax will be due, as the marital deduction will reduce the first decedent's taxable estate to zero.[17] Meanwhile, if the first decedent's executors make a portability election on a timely filed federal estate tax return, the first decedent's unused estate tax exemption is preserved for use by the surviving spouse.

Unlike the federal estate tax exemption, however, the first decedent's New York exemption cannot be inherited by the surviving spouse. Consequently, many planners continue to recommend that the first decedent bequeath an amount equal to the first decedent's New York exemption to a so-called "credit shelter trust" that, although for the benefit of the surviving spouse, does not qualify for the marital deduction. At the surviving spouse's death, the credit shelter trust will pass outside of his or her gross estate. In this manner, the first decedent's New York exemption is not lost or "wasted" but can be used to shield property from New York estate tax at the survivor's death.

A credit shelter trust, however, even if limited to the New York exemption amount, may not always be desirable. As discussed, if the first decedent made $900,000 or more of adjusted taxable gifts, the maxi-

mum taxable estate that can pass free of New York estate tax at the first decedent's death is only $100,000. The amount actually passing to the credit shelter trust may be even less if the first decedent makes pre-residuary bequests that do not qualify for the estate tax marital or charitable deductions. A credit shelter trust worth less than $100,000 may be uneconomical to administer. It may also complicate the administration of the first decedent's estate, by requiring revaluation of assets upon funding or recalculation from time to time of the beneficiaries' respective shares of principal and income. In some cases, the costs of creating and administering a very small credit shelter trust may exceed the potential estate tax savings.

At the same time, a credit shelter trust is not always needed to cause assets to pass free of New York estate tax at the surviving spouse's death. Like assets held in a credit shelter trust, assets transferred via adjusted taxable gifts are excluded from the Computation 1 tax base. Thus, the surviving spouse can effectively remove property inherited from the first decedent from the New York estate tax base by making adjusted taxable gifts. Such gifts will be shielded from federal gift tax by the survivor's own "basic" exemption amount and the additional exemption inherited from the first decedent, if a portability election was made. They will also reduce the total amount of New York estate tax, just as if they had passed outside of the survivor's taxable estate in the form of a credit shelter trust.[18] Finally, gifts have other significant estate tax planning advantages over a testamentary credit shelter trust. For example, unlike a testamentary credit shelter trust, a lifetime gift can be made to a trust that is structured as a so-called "grantor trust" for income tax purposes. The trust may then earn tax-free returns even as the donor's estate is depleted by the income tax liability.[19]

To be sure, the surviving spouse may not wish to relinquish access to and control over his or her wealth, including property passing from the first decedent. To address this concern, the survivor could wait to make gifts until his or her own death is imminent. On the other hand, the surviving spouse may not be able to predict when that will be. Further, by the time the survivor is prepared to make the gifts, his or her wealth may have increased significantly in value.

Those drawbacks can be overcome with proper planning. For example, rather than make a gift of conventional assets, such as cash or securities, the surviving spouse can make a gift of an income interest in one or more qualified terminable interest property (QTIP) trusts created by the first decedent.[20] A gift of an income interest in a QTIP trust will cause the surviving spouse to be deemed to have transferred principal under IRC § 2519.[21] Although QTIP trusts are normally included in the survivor's gross estate under IRC § 2044, that section does not apply if there was a deemed transfer of principal under IRC § 2519. In addition, it seems that the surviving spouse may, without significant risk of gross estate inclusion under other sections of the IRC, continue to receive principal of the QTIP trust at the discretion of an independent trustee.[22] In other words, both future income and appreciation can pass free of both federal and state estate tax at the surviving spouse's death, even though the surviving spouse retains beneficial access to trust principal. Depending on the size of the QTIP trust, a deemed gift under IRC § 2519 can "painlessly" remove more property from the survivor's gross estate than a credit shelter trust that is limited to the first decedent's New York exemption amount.

It should be noted that an estate plan relying on the portability election involves certain potential risks. One is that the surviving spouse may remarry and survive his or her second spouse prior to making lifetime gifts. In that case, the survivor will lose the exemption amount inherited from the first decedent.[23] Such a plan may also not be appropriate in a blended family situation, because it relies on the surviving spouse to make gifts to the first decedent's descendants, and could lead to potential disputes over making the portability election. However, for couples who view these risks as minimal, electing portability and allowing the surviving spouse to make lifetime gifts could result in significant savings in New York estate tax.

Conclusion

Even for experienced attorneys, the calculation of New York estate tax is counterintuitive. As we have seen, although adjusted taxable gifts effectively reduce the maximum taxable estate that can pass free of New York estate tax at death, they nevertheless nearly always save New York estate tax. Estate planners should advise New York resident clients to consider making gifts, regardless of whether their wealth exceeds the federal exemption amount. Finally, a credit shelter trust may not be appropriate for many married New Yorkers, as there are alternative techniques for achieving the same or even better results.

***As this issue went to press, the New York State Tax Reform and Fairness Commission formed by Governor Cuomo released its Final Report (the "Report"). The Report recommends significant reforms to the New York estate tax, including reinstating a New York gift tax in order to remedy the fact that, as discussed in this article, "taxpayers can easily reduce or avoid the [New York] estate tax by making lifetime gifts…." *See* Report at 20. In advising their clients, planners should take into consideration the possible effect of these or other future reforms to the New York wealth transfer tax system.**

Endnotes

1. For an interesting history of the New York estate tax, see E. Schwab, *New Federal Law Impacts New York's Estate Tax*, N.Y.L.J., Apr. 16, 2001, p. 23, col. 5.
2. It should be noted that the state death tax credit did not always provide a complete offset against the total tax burden for state death taxes paid. If the taxable estate included items of income in respect of a decedent (IRD), which are included in the income of the recipient of such items under IRC § 691, the state death tax credit effectively increased the income tax burden of the IRD recipients by reducing the corresponding deduction for estate tax attributable to the items of IRD under IRC § 691(c). For purposes of that deduction, the "estate tax" attributable to the items of IRD refers to the federal estate tax, reduced by any credits against such tax, including the state death tax credit prior to its termination.
3. The deduction is found in IRC § 2058. IRC § 2011(f) now provides that the state death tax credit does not apply to estates of decedents dying after December 31, 2004.
4. IRC § 2001(b) defines "adjusted taxable gifts" as gifts made after 1976 that are not included in the decedent's gross estate. So long as a post-1976 gift is not pulled back into the decedent's gross estate under IRC §§ 2035-42 (often referred to as the "string" sections, which can cause property transferred during lifetime to be included in the decedent's gross estate), it will be treated as an adjusted taxable gift for estate tax purposes.
5. As of the time of this writing, a bill is pending in the New York State Assembly (S. 3035) that would increase the maximum New York exemption amount to $5 million by 2016. However, it would not change the manner in which New York estate tax is calculated, nor would it cause the New York exemption to match the federal exemption.
6. See N.Y. Tax Law § 951(a).
7. The prior version of IRC § 2011 is helpfully reprinted in the appendix to N.Y. Tax Law art. 26.
8. This amount equals $27,600 + 5.6% x ($940,000 - $840,000), as calculated in accordance with the schedule set forth in Appendix A.
9. As the table shows, the Computation 2 amount decreases if the decedent made adjusted taxable gifts in excess of $1 million. The reason for the decrease is that the Computation 2 amount, which represents the hypothetical federal estate tax that would be due under the pre-EGTRRA IRC, is reduced under pre-EGTRRA IRC § 2001(b)(2) by the amount of federal gift tax "which would have been payable" on the decedent's taxable gifts. With a unified credit amount of only $345,800, the decedent's lifetime taxable gifts, if greater than $1 million, would have caused gift tax to have been payable, which in turn reduces the hypothetical amount of federal estate tax which would have been due under the pre-EGTRRA IRC (i.e., the Computation 2 amount). To be sure, given that the actual federal lifetime gift tax exemption amount now exceeds $5 million, the decedent may have paid no federal gift tax at all (or far less gift tax than would have been due if the unified credit had been only $345,800). As the Tax Court held in Estate of Smith v. Commissioner, 94 T.C. 872 (1990), however, it is irrelevant whether gift tax was actually paid or not for purposes of the computing the effective credit for gift tax "which would have been payable" under IRC § 2001(b)(2). The instructions to ET-706 acknowledge this conclusion in the Line 30 worksheet, which states that "[t]ax payable as used here is a hypothetical amount and does not necessarily reflect tax actually paid." But see Pennell & Baskies, *Does the Gift by Promise Plan Work?* (LISI Estate Planning Newsletter #2022) (November 6, 2012) (arguing, but without distinguishing Smith, that gift tax must actually be paid in order for the effective credit for gift tax payable under IRC § 2001(b)(2) to be available).
10. For a New Yorker who has between $1 million and $1,093,785.30 in wealth, the hypothetical federal estate tax, after taking the New York unified credit into account, will be greater than $0. However, that hypothetical federal estate tax (i.e., the Computation 2 amount) will still be lower than the tentative state death credit under Computation 1. According to the authors' calculations, the "threshold" at which the hypothetical federal estate tax under Computation 2 (assuming that lifetime gifts do not exceed $1 million) equals the tentative state death tax credit under Computation 2 is $1,093,785.30.
11. If gift tax is payable on the gifts, the gifts will still be included in the estate tax base as adjusted taxable gifts (or under one of the IRC's "string" sections). However, the donor's estate will receive the equivalent of a credit for the gift tax payable under IRC § 2001(b)(2). For a discussion of the mechanics of this credit, see A. Bramwell, *Gift-by-Promise Plan Works as Advertised* (LISI Estate Planning Newsletter #2033), Dec. 3, 2012.
12. Although references to the IRC in N.Y. Tax Law art. 26 are generally deemed to be references to the pre-EGTRRA IRC, New York does not appear to require, for purposes of IRC § 2035(b), a hypothetical computation of federal gift tax payable under the pre-EGTRRA IRC. Thus, it seems that the New York gross estate only includes federal gift tax on gifts made within three years of death to the extent that gift tax was actually payable under the (post-EGTRRA) IRC. It does not appear to include gift tax that hypothetically would have been payable on lifetime gifts under the pre-EGTRRA IRC. *Cf.* N.Y. Tax Law § 961(a)(1) (providing that a final federal determination of the inclusion of an item in the gross estate shall also determine whether it is included for New York estate tax purposes). By contrast, as discussed *supra* note 10, the computation of the effective credit under IRC § 2001(b)(2) for gift tax "which would have been payable" *does* require a hypothetical computation of gift tax, even if none was actually paid.
13. A similar example is provided in J. Blattmachr & M. Gans, *The Quadripartite Will: Decoupling and the Next Generation of Instruments*, 32 Estate Planning 3 (April 2005), which contains an excellent discussion of the effect of lifetime gifts on the New York exemption amount.
14. IRC § 1014 generally provides (subject to exceptions, such as for income in respect of a decedent) that property acquired from a decedent shall have a basis equal to the fair market value of the property at the date of the decedent's death. In contrast, a donee's basis in gifted property is generally equal to the donor's basis in such property at the time of the gift. IRC § 1015.
15. A. Bramwell & V. Kanaga, *The Section 2519 Portability Solution*, Trusts & Estates (June 2012); A. Bramwell, *How to Use Portability to Avoid (Not Just Defer) State Death Taxes* (LISI Estate Planning Newsletter #1991), July 24, 2012; J. Blattmachr, A. Bramwell & D. Zeydel, *Portability or No: The Death of the Credit Shelter Trust?*, 118 Journal of Taxation 5 (May 2013).
16. *But see* J. Blattmachr & M. Gans, *supra* note 13 (offering a technique for avoiding New York estate tax on the amount of the first decedent's federal exemption using Rev. Proc. 2001-38).
17. The first decedent's GST exemption under IRC § 2631 is not "wasted" so long as his or her assets pass, for example, to a "reverse" QTIP trust for the benefit of the surviving spouse to which the first decedent's GST exemption is allocated. IRC § 2652(a)(3).
18. Gifts will not reduce New York estate tax, however, if the sum of the survivor's taxable estate and adjusted taxable gifts would, but for the assets inherited from the first decedent, have been less than $1 million. Thus, a credit shelter trust may be preferable if the survivor's wealth is less than $1 million. Flexibility may be preserved through disclaimers and/or partial QTIP elections, including QTIP elections subject to "Clayton" provisions. *See generally* J. Blattmachr, A. Bramwell & D. Zeydel, *supra* note 15.
19. *See* Rev. Rul. 2004-64 (ruling that the payment of income tax by the grantor of a grantor trust does not constitute an additional gift to the trust because the income tax liability was that of the grantor, not the trust).

20. This type of planning is explained in further detail in A. Bramwell & V. Kanaga, *supra* note 15; *A. Bramwell & V. Kanaga on PLR 201243004*, (LISI Estate Planning Newsletter #2040), Dec. 20, 2012, and J. Blattmachr, A. Bramwell & D. Zeydel, *supra* note 15. *See also* A. Bramwell, *Using Section 2519 to Enhance Estate Planning with QTIP*s, 38 Estate Planning 10 (Oct. 2011).

21. The survivor should not have a power over the trust, such as a special power of appointment, that may cause the deemed gift of principal to be incomplete for gift tax purposes. Cf. Treas. Reg. 25.2511-2(b).

22. *See* Rev. Rul. 2004-64, for example, in which the IRS ruled that a trustee's discretion to reimburse the grantor for income tax due on the income of a grantor trust did not, absent other facts (such as an implied understanding between the grantor and the trustee), cause inclusion under IRC § 2036(a)(1), even though the trustee had the discretion to make a payment in satisfaction of an obligation of the grantor. *See also* Priv. Ltr. Rul. 200944002 (Oct. 2009) (stating "the trustee's discretionary authority to distribute income and/or principal to [the grantor], does not, by itself, cause the [t]rust corpus to be includible in [the grantor's] gross estate under § 2036"). Also note that the surviving spouse should not have a power of appointment over the corpus of the QTIP trust(s), in order to avoid inclusion under IRC §§ 2036(a)(2) or 2038. Finally, the surviving spouse should not have a power to participate in decisions to distribute principal, even if limited to a standard. *Cf. Estate of Sullivan*, T.C. Memo 1993-531 (holding that the principal of a trust was included in the decedent's gross estate where the decedent retained a power to make distributions that, although limited to a standard, could be used to satisfy his own support obligations).

23. IRC § 2010(c)(4)(B) (providing that, with respect to a surviving spouse, the "deceased spousal unused exclusion amount" is the lesser of (a) the basic exclusion amount, or (b) the remaining applicable exclusion amount of the "*last such deceased spouse* of such surviving spouse") (emphasis added).

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APPENDIX A

Tentative Credit under Pre-EGTRRA IRC § 2011(b)

If the adjusted taxable estate is:	The maximum tax credit shall be:
Not over $90,000	8/10ths of 1% of the amount by which the adjusted taxable estate exceeds $40,000
Over $90,000 but not over $140,000	$400 plus 1.6% of the excess over $90,000
Over $140,000 but not over $240,000	$1,200 plus 2.4% of the excess over $140,000
Over $240,000 but not over $440,000	$3,600 plus 3.2% of the excess over $240,000
Over $440,000 but not over $640,000	$10,000 plus 4% of the excess over $440,000
Over $640,000 but not over $840,000	$18,000 plus 4.8% of the excess over $640,000
Over $840,000 but not over $1,040,000	$27,600 plus 5.6% of the excess over $840,000
Over $1,040,000 but not over $1,540,000	$38,800 plus 6.4% of the excess over $1,040,000
Over $1,540,000 but not over $2,040,000	$70,800 plus 7.2% of the excess over $1,540,000
Over $2,040,000 but not over $2,540,000	$106,800 plus 8% of the excess over $2,040,000
Over $2,540,000 but not over $3,040,000	$146,800 plus 8.8% of the excess over $2,540,000
Over $3,040,000 but not over $3,540,000	$190,800 plus 9.6% of the excess over $3,040,000
Over $3,540,000 but not over $4,040,000	$238,800 plus 10.4% of the excess over $3,540,000
Over $4,040,000 but not over $5,040,000	$290,800 plus 11.2% of the excess over $4,040,000
Over $5,040,000 but not over $6,040,000	$402,800 plus 12% of the excess over $5,040,000
Over $6,040,000 but not over $7,040,000	$522,800 plus 12.8% of the excess over $6,040,000
Over $7,040,000 but not over $8,040,000	$650,800 plus 13.6% of the excess over $7,040,000
Over $8,040,000 but not over $9,040,000	$786,800 plus 14.4% of the excess over $8,040,000
Over $9,040,000 but not over $10,040,000	$930,800 plus 15.2% of the excess over $9,040,000
Over $10,040,000	$1,082,800 plus 16% of the excess over $10,040,000

For purposes of this section, the term "adjusted taxable estate" means the taxable estate reduced by $60,000.

The Promise of a Tasty Dessert Cannot Replace a Healthy Entree: Why Portability Is Not a Substitute for Estate Planning

By Philip J. Michaels and Brian G. Smith

Overview

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("TRA 2010") first introduced the concept of "portability" to the world of estate planning and estate administration.[1] It became effective starting on January 1, 2011 and like the other gift and estate tax laws included in TRA 2010, it was scheduled to "sunset" on December 31, 2012. Unlike the increased gift tax exemption amount of which many taxpayers took advantage throughout 2011 and 2012, portability was not an advantage that could be "planned for" during that time span. Portability only applies to a decedent dying after January 1, 2011, and with the window scheduled to close merely two years later, estate planners did not even begin to consider whether making portability an active part of a client's estate plan would make sense.

The enactment of the American Taxpayer Relief Act of 2012 (the "2012 Relief Act") increased the gift and estate tax exemptions and extended portability indefinitely.[2] Portability allows a surviving spouse to potentially preserve a predeceased spouse's unused federal estate tax exclusion amount, which is currently $5.25 million, less the amount used by the predeceased spouse during his or her life and at his or her death. This amount is referred to as the "Deceased Spousal Unused Exclusion Amount" or "DSUE Amount." In this new estate and gift tax environment, consideration should be given to whether portability makes some of the estate planning strategies we have all grown accustomed to using unnecessary and burdensome, or whether portability should simply be a failsafe for clients who do not actively engage in planning prior to the first spouse's death.

How Does Portability Work?

Upon the death of the first spouse to die, any of that spouse's unused gift and estate tax exemption amount can be passed to the surviving spouse. "Inheriting" a $5,250,000 DSUE Amount can be worth up to $2,100,000 in federal estate tax savings for the surviving spouse's estate.[3] This makes the DSUE Amount an extremely valuable asset which may even need to be negotiated for in pre-nuptial agreements.

The following example illustrates portability in action: Husband ("H") makes $2 million of gifts during his lifetime, and dies in May 2013, and uses $1,000,000 of his available estate tax exemption at his death, with the balance of assets passing outright to his wife. H's estate will have $2.25 million of unused exemption still available. If the executor of his estate makes an election on a timely filed federal estate tax return electing portability, H's wife ("W") will "inherit" H's $2.25 unused exemption amount. If W has not used any of her unified gift and estate tax exemption during her lifetime, she would have $7.5 million of available exemption for lifetime gifting *or* to be used by her estate at her death. In this illustration W's estate has potentially saved an additional $900,000 in federal gift and estate taxes due to portability.[4] For any individual who dies leaving some DSUE Amount, it is prudent for the executor to elect portability on a timely filed Form 706, thereby providing the surviving spouse the opportunity for additional federal gift and estate tax savings.[5]

This is especially useful if (i) H dies young and H and W have a combined estate of $5.25 million or less, or (ii) if H and W have unbalanced assets, such that W has significant wealth, and H has more modest wealth, and H and W had not yet equalized their wealth to take advantage of both exemptions.

The DSUE affords a great deal of flexibility of which W can take advantage by making taxable gifts during her lifetime or through her estate at her death. For example, W could create an irrevocable trust to which she transfers $7.5 million of securities, and none of it will result in a federal gift tax to W because of portability.

It is highly recommended that portability is used as early as possible by making gifts during a lifetime if the predeceased spouse dies leaving a DSUE Amount, to the extent the surviving spouse has sufficient assets to afford to make substantial gifts and still live comfortably. The reasons for taking advantage of the DSUE Amount early are twofold: first, although portability is permanent, Congress can always act and change the law, so it is better to make gifts using the DSUE Amount while it is available; and second, if the survivor remarries, portability can become somewhat complicated and actually result in a loss in the DSUE Amount received.

For example, we will use the same facts as above where W now has $2.25 million in a DSUE Amount from her predeceased husband, H, and still has her entire exemption amount of $5.25 million, for a total

available exemption amount of $7.5 million. If W now marries H2, she is only able to use her *last deceased spouse*'s DSUE Amount, which would still be H during H2's lifetime. However, if H2 dies suddenly, and uses up his full $5.25 million of exemption in testamentary bequests, W would have lost her entire DSUE Amount from H, because H is no longer her last deceased spouse, and H2 used his entire available exemption, leaving W with no DSUE Amount.[6] At a 40% top marginal tax rate, W's estate may now have to pay an additional $900,000 in taxes because W did not use H's DSUE Amount before H2 died. If instead, W had given away $2.25 million before marrying H2, or while married to H2 but before his death, she would have been able to take advantage of H's DSUE Amount while retaining her $5.25 million exemption. If H2 later died without using his full exemption amount, W could take advantage of portability again and acquire H2's DSUE Amount.

Burdens of Portability

In addition to the executor needing to affirmatively elect portability on the first deceased spouse's timely filed federal estate tax return, portability is burdensome in a couple of other ways. First, the statute of limitations on the IRS challenging the first deceased spouse's filed estate tax return is extended for certain purposes. Instead of the three-year statute of limitations that the IRS normally has in order to challenge a filed return, the IRS can review the first deceased spouse's return until three years *after the filing of the survivor's estate tax return* for the purposes of calculating the first deceased spouse's DSUE Amount.[7] This could potentially extend the statute of limitations by decades regarding the valuation of certain assets of the first deceased spouse's timely filed federal estate tax return. If the first deceased spouse died with various illiquid hard-to-value assets such as interests in family limited partnerships, or other assets for which discount appraisals were utilized, electing portability could result in an after-the-fact audit which could result in significant cost to the estate, which would presumably be paid for by the survivor's estate. The increased chance of audit and the potential cost to the survivor's estate would have to be taken into account when considering whether to elect portability. It also raises the question of whether an executor would have a duty to consider not electing portability to close the audit window sooner if the executor felt the audit risk was high and could potentially be a burden on the survivor's estate. In connection with this, what right would a surviving spouse have, if any, to challenge an executor who refuses to elect portability and/or somehow elect portability another way?

Moreover, in order for a couple with minimal assets to take advantage of portability, the executor of the first deceased spouse's will would have to file a federal estate tax return (Form 706) when one would not otherwise be required, costing the estate additional legal and/or accountant fees. In the case of a young family with minimal assets it may make sense to file a federal estate tax return and elect portability but consideration should be given to whether the surviving spouse will acquire enough assets to deem the DSUE Amount beneficial to him or her. This will be another difficult balancing test that the executor will need to contemplate.

Portability Is Just a Failsafe

If one were planning a dinner party, he would not count on the port and Stilton bleu cheese being served for dessert to carry the meal. Instead, the focus would be on the main course, and a full-bodied wine would be selected to impress guests and keep them happy throughout the meal. If one of the guests happens to detest the meal, the port and Stilton dessert can be somewhat of a failsafe, as it is a heavenly combination, touted by wine and cheese connoisseurs and novices alike, that will leave even the most disappointed guest satisfied.

Similar to port at a dinner party, portability should only be used as a failsafe for clients who have not adequately planned. It is important for taxpayers to understand that a full and complete estate plan that not only guarantees the use of both parties' full gift and estate tax exemptions, but also the complete use of each spouse's generation-skipping transfer ("GST") tax exemption, while enjoying the many benefits of credit shelter trusts which can shelter appreciation, protect assets against creditors, litigation, matrimonial issues, and children and/or grandchildren inheriting wealth before they have the financial maturity to manage it.

1. GST Exemption Is Not Portable

Although the gift and estate tax exemption is portable under the 2012 Relief Act, the GST tax exemption (which is also $5.25 million in 2013) is *not* portable. Therefore, if a client dies without using it during his or her lifetime or upon his or her death, it will be lost forever and cannot be used by his or her surviving spouse.

For example, if H dies with a $10 million estate, and leaves everything to W outright, W can receive the benefit of H's $5.25 million DSUE amount for gift and estate tax purposes (if a proper election is made); however, H's GST tax exemption will be lost forever.[8] When W dies (or when W makes gifts during her lifetime), she will be able to give away $10.5 million free of gift and estate tax, but only half of that amount will be free of GST tax. This may result in GST tax payments when the assets held by the lifetime trusts set up for her children are distributed—either outright or in further trust—to her grandchildren and more remote descendants. If H had planned and taken advantage of his

GST tax exemption, the couple could have ultimately distributed *twice* as much wealth to their grandchildren and more remote descendants completely free of gift, estate, *and* GST tax.

2. Creditor (and Predator) Protection

One of the major motivations behind a comprehensive estate plan is the creditor protection for assets held in trusts. Typically, a client with significant wealth would create a "credit shelter trust" with his or her spouse and descendants as discretionary sprinkle beneficiaries. These assets are completely shielded from creditors making any claims against the beneficiaries of the trust. Upon the surviving spouse's death, if these assets are divided among the client's descendants and held in further lifetime trusts for the benefit of each beneficiary, these assets will continue to be protected from creditor and matrimonial claims. Moreover, these assets are still deemed as passing from, and taking advantage of, the initial client's gift, estate, and GST tax exemptions, and therefore they are free of these taxes for as long as they remain in trust.

In addition to creditors, the credit shelter trust (as well as any other trust properly set up to take advantage of asset protection), protects against marital claims of the second spouse of the client's surviving spouse, or spouses of the client's descendants. If the trusts are set up properly they will prohibit any trustee/beneficiary from making discretionary distributions to himself or herself, thereby providing these descendants with an added layer of protection. In addition to potential matrimonial claims, drug, alcohol, gambling and spending problems can create financial risks and landmines for a beneficiary. A properly drafted discretionary trust can provide the beneficiary with the time and support needed to address their challenges while preserving the trust assets.

These protections afforded to assets held in trust can often motivate married clients to equalize their wealth, so that they can each take advantage of their full gift, estate and GST tax exemption amounts, fund credit shelter trusts under each Will to the extent possible, and transfer more assets in trust for the benefit of the surviving spouse. If the first deceased spouse has few assets in his or her own name, the surviving spouse will not be able to set up a trust for his or her own benefit while protecting those assets without utilizing extremely complicated estate planning techniques. It is much easier and much more economical for married clients to equalize their wealth and create trusts for the surviving spouse on the first deceased spouse's death.

It is important to note that there are ways to use portability as part of an active estate plan. For example, the surviving spouse could immediately create irrevocable inter vivos trusts using the DSUE Amount after his or her spouse's death to shelter the assets properly; however, if the assets were held in the surviving spouse's own name (and not in the first deceased spouse's name at his or her death), these assets would not receive a basis step-up upon transfer to the trusts, nor would the surviving spouse be able to continue to enjoy the benefit of them. Another option is to create a QTIP Trust which provides for asset protection, while allowing the surviving spouse to inherit a DSUE Amount.; however, QTIP Trusts are much more common when planning for couples when at least one of the spouses is on his or her second or third marriage, and much less common or well received when the planning is for a couple where it is the first marriage for both spouses. Thus, it is not advisable to recommend a QTIP Trust when one can take advantage of the DSUE Amount in the testamentary plan of the first spouse to die, rather than trying to "sell" spouses on QTIP trusts simply to take advantage of portability.

3. Shelter Growth from Estate and Gift Taxes

When a testamentary credit shelter trust is funded, and GST properly allocated, future appreciation on the trust assets are sheltered from future estate, gift, and GST tax. On the surviving spouse's death, or future beneficiary's death, for as long as the assets are held in trust, they will not be subject to additional estate, gift, and GST tax. If a couple relies on portability, whether the assets are placed into a QTIP Trust or are distributed outright to the surviving spouse, the post mortem appreciation on those assets will be included in the surviving spouse's taxable estate at his or her death, and subject to estate tax on all of the appreciation.

The impact of post mortem appreciation can be mitigated if the surviving spouse immediately gifts the property into an inter vivos irrevocable trust, using the inherited DSUE Amount. In this case, only the appreciation, if any, in the short time between the first spouse's death and the gift would have been subject to additional gift/estate tax. But the best approach would be to establish a credit shelter trust allowing the client to take advantage of sheltering growth while still allowing the surviving spouse to enjoy the property during his or her lifetime.

One benefit to portability in this scenario, which is not available to those sheltering growth through the use of a credit shelter trust, is the step-up in basis on the death of the surviving spouse. Whether the property is held in a QTIP trust or outright by the surviving spouse, upon the surviving spouse's death, the property will receive a step-up in basis. While this is an added benefit, the effective tax rate on long term capital gains is less than the estate tax, so in most cases, the benefit of the step-up in basis for income tax purposes will not outweigh the additional federal taxes on growth now subject to estate tax. Moreover, if the surviving spouse

and/or the descendants do not intend to sell the property, the step-up is significantly less important.

4. State Estate Taxes

To date, no state has enacted legislation that allows residents to take advantage of portability on a state level—the 2012 Relief Act only applies to federal estate and gift tax. Thus, if a client relies on portability and does not fund a credit shelter trust, or another trust taking advantage of the state estate tax exemption, it will be lost forever. Proponents of portability as an active planning tool may claim that state estate tax can actually be avoided under portability because the surviving spouse could make a gift of up to $10.5 million in his or her lifetime, free of state estate tax (unless the client is a Connecticut resident or the gift is of Connecticut real and tangible personal property, as Connecticut is the only state in the country that imposes a state gift tax); however, this point is not well taken.

If clients have sufficient assets to make large gifts to take advantage of the federal gift tax exemption available during their lifetimes, lifetime gifts can help to minimize state estate tax due. Again, portability here can be used as a failsafe, but a client who was not motivated to engage in gifting before the loss of a spouse may be even less motivated to begin gifting immediately after the death of their spouse. Moreover, the surviving spouse would not be able to enjoy any property he or she gifts away to take advantage of the DSUE Amount he or she inherited.

5. Management

Creating trusts under the will of the first deceased spouse allows clients to establish a management structure with which they are comfortable by appointing fiduciaries to serve as trustees who can properly manage the assets. These trustees' duties will not only include making investment decisions and/or hiring investment professionals, but also making decisions regarding distributions. A well-chosen fiduciary can become a trusted advisor to a surviving spouse. Relying on portability can leave the survivor the unfamiliar task of managing significant assets. Having this management structure in place can provide a valuable asset management system, which can also protect the survivor in the event of future incapacity. This form of asset protection planning reduces the need for future property guardianship proceedings, and reduces the risk of financial exploitation. Setting up trusts and establishing a management team under the first deceased spouse's will or inter vivos trust greatly reduces these risks, while allowing for seamless and prudent asset management.

Conclusion

It is extremely helpful for clients and estate planning attorneys alike that TRA 2010 and the 2012 Relief Act established portability and made it permanent. Portability allows clients who did not set up a proper estate plan to engage in post mortem estate tax planning without completely losing the DSUE Amount of the predeceased spouse. There can be many considerations that go into clients thinking why they may or may not be willing to "equalize" the ownership of assets between a husband and wife, and whether they are comfortable setting up trusts or are adverse to them. It is important that estate planners advise clients of the reasons and benefits of creating and implementing a comprehensive estate plan. It is important that we educate the public and dispel the notion that portability dispenses with the need for comprehensive and proactive estate planning.

Endnotes

1. TRA 2010 Title III Section 303 *(*amending 26 U.S.C. § 2010(c) effective January 1, 2011).
2. 2012 Relief Act Title I Section 101(a) (extending TRA 2010, including Title III, Section 303, effective January 1, 2013).
3. We have determined this amount by multiplying the $5,250,000 DSUE Amount by the top marginal estate and gift tax rate of 40%. This calculation results in the sum of $2,100,000 and is the maximum amount one could save by "inheriting" a $5.25 million DSUE Amount. Depending on the surviving spouse's assets, however, the actual amount saved by the surviving spouse's estate due to inheriting a DSUE Amount could be anywhere from $0 to $2.1 million.
4. Depending on W's assets at her death, the additional DSUE Amount could save her estate anywhere between $0 to a maximum of $900,000 based on the same calculation using the top marginal rate of 40%.
5. It is unclear whether Section 9100 relief is available for a missed election. 26 U.S.C. § 2010(c)(5)(A) ("No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return").
6. W will be left with $5.25 million in exemption rather than $7.5 million.
7. 26 U.S.C. § 2010(c(5)(B).
8. Depending on the terms of the Will, the Wife may be able to disclaim assets in order to allow H's estate to take advantage of H's available GST exemption as well.

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The Pros and Cons of Establishing a Not-for-Profit Corporation Versus a Charitable Trust in New York

By Andrew S. Katzenberg

High net worth clients often have philanthropic desires and objectives, and one method to achieve these goals is to establish a private charity, also known as a private foundation. Instead of giving to a public charity, clients can establish their own private foundation. Foundations provide several advantages that clients may not have considered when deciding to make charitable gifts.

First, most gifts to a private foundation will be tax deductible to a similar extent as gifts to a public charity.[1] This allows the client to make larger current gifts which result in a larger tax deduction, even though he or she does not plan on distributing those funds in that same year to other charities. In other words, clients can take a deduction up front and make distributions to the client's preferred charities over time. Second, the client can be a director or trustee and / or can appoint directors and trustees, giving him or her control over the foundation's investments and charitable grants. Third, family members can participate in the foundation, which can be used to educate younger generations about the importance and benefits of philanthropy. Finally, a client can secure his or her legacy through the benevolent acts of the foundation for decades after the client's death.

Once a client has decided to create a foundation, it then falls to the attorney to recommend which type of entity to establish based on the client's objectives. This article will focus on the advantages and disadvantages of establishing not-for-profit corporations and charitable trusts in New York.

I. Not-for-Profit Corporations

Not-for-Profit Corporations, also known as charitable corporations, can be formed under New York's Not-for-Profit Corporations Law (NPCL).[2] To qualify as a Not-for-Profit Corporation, a corporation must meet specific and rigid requirements,[3] including, but not limited to, the following.

Like all New York corporations, it must file for incorporation with the New York State Department of State.[4] The certificate of incorporation must state the specific purpose or purposes for its creation.[5] The purpose cannot be too vague or broad[6] such as using Section 501(c)(3)'s tax exempt purpose language[7] alone as the description of the purposes.[8] The purpose or purposes article should identify (i) what the corporation intends to accomplish, (ii) who will benefit and (iii) how it will accomplish its purposes.[9]

A corporation is also required to have a minimum of three directors.[10] The directors' names and addresses need to be listed in the certificate of incorporation.[11]

The name of the corporation usually must include the word "corporation," "incorporated," "limited," or their abbreviations to identify the corporate nature of the entity.[12] There are several exceptions to this rule, but they are limited in focus.[13] One exception to the name requirement is for corporations that are created solely for charitable or religious purposes.[14] However, if the purpose article includes any other purposes, then it is not exempt and must use one of the identifying words or abbreviations in its name. For instance if the corporation had both charitable and educational purposes, it would not qualify for the exception.[15] However, a corporation could request permission from New York's Department of State to do business under an "assumed name," rather than its legal name.[16]

Foundations with certain purposes, such as education or operation of hospital or health services, are also required to obtain consent from other corresponding governmental agencies or offices to qualify for incorporation (*i.e.*, Department of Education and Department of Health respectively).[17] Foundations with purposes that include business purposes must include an additional statement explaining the public and quasi-public objectives its business purpose will achieve.[18]

One cannot avoid New York's difficult incorporation laws by incorporating in another jurisdiction such as Delaware. These charitable corporations are considered foreign charitable corporations[19] and are required to file an "application for authority" with New York's Department of State if they intend to "conduct business"[20] in New York.[21] Though a foreign charitable corporation does not have to satisfy as many requirements as a charitable corporation incorporated in New York, it must still define the specific purposes of the charitable corporation in the application for authority.[22]

II. Charitable Trusts

Charitable trusts are governed under Article 8 of New York's Estate, Powers & Trusts Law (EPTL).[23] The statutes governing charitable trusts are not as rigid as the Not-for-Profit Corporations Law.

When establishing a charitable trust under New York law, one should follow the same rules as creating any other lifetime trust, which merely requires the signatures of the creator and one of the trustees, all of which are witnessed by two individuals or notarized.[24]

A bigger advantage of a charitable trust is that a trust does not need to have as specific a charitable purpose(s) as a charitable corporation.[25] This means the trust can have several broad charitable purposes (*e.g.*, religious, charitable, educational, or benevolent purposes) and could use Section 501(c)(3)'s tax exempt language alone as the description of the purposes. This is helpful when a client does not have a specific purpose in mind or has multiple purposes in mind.

Further, a trust only needs one trustee instead of three directors,[26] and a trust can always allow for additional trustees to be appointed at a later date.[27] A client may not have three people he or she wants to manage the charity, and this would simplify the initial decision.

There are no requirements for a trust's name. It can be called the "John Doe Foundation," the "Lucky Day Trust," or any other name a client cares to use. It also does not need consent of any New York governmental agency to be established such as the Department of Education or the Department of Health (except it must register with the New York Charities Bureau the same as a charitable corporation[28]).

Another advantage of a charitable trust is that the creator can make the purposes irrevocable whereas a charitable corporation's certificate of incorporation can always be amended by the board of directors.[29] If the purpose of the charitable trust becomes impractical after the creator's death, the trustee may petition the court to change the specific purpose to accomplish the general purpose of the trust.[30]

Despite these advantages, the scale is not completely tipped in favor of charitable trusts over charitable corporations. First, under New York's Surrogate's Court Procedure Act, trustee compensation is limited to six percent (6%) of income and none of the principal of the trust.[31] Directors of corporations, on the other hand, are limited to "reasonable compensation" without any firm caps.[32]

Second, charitable trusts can be subject to higher taxes than charitable corporations. "Unrelated business taxable income" (UBTI) is subject to tax at the normal tax rates for corporations and trusts.[33] A trust's highest tax rate is 39.6% and reaches this amount at $11,950 (adjusted for inflation) of UBTI[34] whereas a corporation's highest bracket is 35%,[35] which takes effect at $10 million of UBTI.[36]

III. Liability of Directors and Trustees

The biggest disadvantage of a charitable trust is that the trustee is exposed to greater personal liability then a corporate director. Directors and officers of corporations owe a duty of care,[37] loyalty and obedience[38] to the corporation, which opens them up to personal liability. However, there are specific laws that protect directors and officers of charitable corporations from liability, such as mandatory indemnification,[39] in addition to broader indemnification that may be granted or authorized by the certificate of incorporation or by-laws.[40] Directors and officers are also protected by the business judgment rule, which protects them from liability as long as their actions are "taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."[41]

Directors may also delegate investment authority to officers or employees without being held liable for those individuals' actions.[42] Essentially, the directors can insulate themselves from liability on investment decisions by delegating authority.

On the other hand, trustees have a fiduciary duty to exercise reasonable care, diligence and prudence.[43] This is analogous to a corporation's director's duty of care. Additionally, trustees' investment and management actions are also governed by the Prudent Investor Rule, which does not apply to directors, resulting in a higher fiduciary duty.[44] Under this rule, the trustees' investment and management actions are judged based on all circumstances and facts at the time of their decisions to determine if they acted in accord with a prudent investor.[45]

Though the Prudent Investor Rule allows for the delegation of investment authority by the trustee, the trustee must exercise "care, skill and caution" in such delegation and must periodically review delegee's exercise of authority.[46] In addition, the trustee may still be liable for negligent acts of the delegee, unlike a corporate director.[47]

As mentioned above, the NPCL specifically protects the acts of the directors and officers, whereas the EPTL is silent on the issue.[48] The trustee is also not protected by the business judgment rule.[49] However, the flexibility of the trust instrument allows one to build in limited liability and indemnification for the trustee, though not to the same extent as provided to directors and officers.

IV. Conclusion

Charitable trusts are easy to form in New York and are amenable to expanded charitable purposes, while charitable corporations provide greater protection from liability for their directors and officers and lower taxes on UBTI. Greater protection from liability in itself does not further the client's charitable goals; this is merely an ancillary benefit for the individuals managing the charitable organization.

Therefore, when initially setting up a charitable organization in New York for high net worth clients, a

charitable trust is normally the best starting point. As your client's foundation grows and his or her objectives become clearer, he or she can always create a charitable corporation at a later point to receive the funds of the charitable trust. This strategy will allow the foundation to get up and running sooner while providing the additional benefits of a corprate structure in the future.

Endnotes

1. The maximum amount of gifts to a public charity that may be deducted in a year is 50% of one's adjusted gross income, and this amount is further reduced to 30% for appreciated property. The maximum amount of gifts to a private foundation that may be deducted in a year is 30% of one's adjusted gross income, and this amount is further reduced to 20% for appreciated property, though gifts made to private operating foundations and, in rare cases, private foundations can qualify for a deduction amount of up to 50% of one's adjusted gross income. IRC 170(b) (2013); *see also* I.R.S., *Publication 526: Charitable Contributions* 13-14 (Jan. 18, 2013), *available at* http://www.irs.gov/pub/irs-pdf/p526.pdf (last visited July 29, 2013).
2. N.Y. Not-for-Profit Corporations Law § 402(a)(2) (NPCL).
3. NPCL § 402(a) (listing several requirements for the corporation's certificate of incorporation).
4. NPCL § 403 ("Upon the filing of the certificate of incorporation by the department of state, the corporate existence shall begin, and such certificate shall be conclusive evidence that all conditions precedent have been fulfilled and that the corporation has been formed under this chapter…").
5. NPCL § 402(a)(2); *see also* NPCL § 201 (establishing the purposes for which a corporation may be formed under the NPCL).
6. *See In re Council for Small Bus., Inc.*, 155 N.Y.S.2d 530, 530 (Sup. Ct., Kings Co. 1956) (denying an application for incorporation because "[t]he purposes outlined in the proposed certificate of incorporation are too generalized and vague"). *See also, In re Aid Found., Inc.*, 27 Misc. 2d 314, 315, 210 N.Y.S.2d 165, 167 (Sup. Ct., Kings Co. 1960) (denying application for incorporation of a corporation, which claimed "exclusively charitable" purposes, but provided only "vague" and "unclear" description of the charity's scope and proposed activities). If a certificate of incorporation does not specify the charitable organization's purpose(s), it will not qualify as a Not-for-Profit Corporation.
7. "[O]rganized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals." IRC § 501(c)(3).
8. *See* N.Y. Dep't of State, *Not-for-Profit Incorporation Guide* (January 2012), *available at* http://www.dos.ny.gov/forms/corporations/1511-f-l_instructions.pdf (last visited September 16, 2013).
9. *Id.*
10. NPCL § 702(a).
11. NPCL § 402(a)(4). However, type D corporations need not list names and addresses of initial directors. *Id.*
12. NPCL § 301(a)(1). Abbreviations include "Inc.," "Corp.," or "Ltd."
13. A corporation falls within the exception if (i) it is formed for charitable or religious purposes, (ii) it is formed for purposes that require approval by the commissioner of social services or the public health and health planning council, or (iii) it is a bar association. NPCL § 301(a)(1).
14. NPCL § 301(a)(1).
15. *See* NPCL § 301(a)(1) (failing to exempt corporations with educational purposes from the name requirement).
16. N.Y. General Business Law § 130 (GBL). For the link to Department of State, *see* N.Y. Dep't of State, Div. of Corps., State Records & UCC, *Certificate of Assumed Name*, http://www.dos.ny.gov/corps/assdnmins.html (last visited July 29, 2013) (providing instructions for how to file a certificate for assumed name with the Department of State).
17. NPCL § 404. Some of the agencies whose consent is required include Office of the Attorney General, Office of Children & Family Services, Department of Health, Department of Education, Office of Mental Health and Office of Alcoholism and Substance Abuse Services. *Id.*
18. NPCL § 402(a)(2).
19. NPCL § 102(a)(7).
20. *See* N.Y. Dep't of State, *"Doing Business" In New York: An Introduction To Qualification General Guidelines* (February 2000), *available at* http://www.dos.ny.gov/cnsl/do_bus.html (last visited October 6, 2013). It is not entirely clear what constitutes doing business in New York but NPCL § 1301 does have a nonexclusive list of acts which do not constitute doing business in New York such as maintaining bank accounts or granting funds.
21. NPCL Article 13. For the link to Department of State, *see* N.Y. Dep't of State, Div. of Corps., State Records & UCC, *Application for Authority*, http://www.dos.ny.gov/forms/corporations/1555-f-l-a.pdf (last visited October 10, 2013).
22. NPCL § 1304.
23. The provisions under EPTL Article 7 governing trusts should also be considered when dealing with a charitable trust and should be used when the provisions of EPTL Article 8 do not provide guidance. *See generally* EPTL 7-1.1–7-8.1.
24. EPTL 7-1.17(a). This Section refers to "every lifetime trust," which would include charitable lifetime trusts, since they are not excluded from the definition of lifetime trust under EPTL 1-2.20. However, prior to 1997, there was no formal requirement for the execution of lifetime trusts (except for pour-over trusts). Turano, McKinney's Practice Commentary, EPTL 7-1.17 (2012).
25. *Cf.* NPCL § 201 (requiring not-for-profit corporations to specify a charitable purpose, unlike trusts).
26. *Compare* EPTL 7-1.17(a) (providing that trust must be executed "by at least one trustee"), *with* NPCL § 702(a) ("The number of directors constituting the entire board shall be not less than three.").
27. *See* EPTL 7-1.17(b) (outlining the requirements governing amendments to a trust).
28. EPTL 8-1.4.
29. NPCL § 801.
30. EPTL 8-1.1(c).
31. N.Y. Surrogate's Court Procedure Act 2309(5) (SCPA).
32. 26 C.F.R. § 53.4958-4(b).
33. IRC § 511(a)(2) and (b)(2).
34. IRC § 1(e).
35. However, any amount UBTI between $100,000 and $335,000 is taxed at a 39% rate and any amount UBTI between $15,000,000 and $18,333,333 is taxed at a 38% rate. IRC § 11(b)(1)(D). *See also*, Form 1120 Instructions for 2012 page 17, *available at* http://www.irs.gov/pub/irs-pdf/i1120.pdf (last visited October 8, 2013).
36. IRC § 11.
37. NPCL § 717.

38. *See* N.Y. Dep't of State, Charities Bureau, *The Regulatory Role of the Attorney General's Charities Bureau* 4 (July 15, 2003), *available at* http://www.courts.state.ny.us/reporter/webdocs/role.pdf (last visited July 29, 2013); *see also Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 186 Misc. 2d 126, 152, 715 N.Y.S.2d 575 (Sup. Ct., New York Co. 1999).

39. NPCL § 723(a). Indemnification is mandatory if a director is successful on the merits of a case. *Id.*

40. NPCL § 721 (providing that the indemnification and advancement of expenses under the NPCL are non-exclusive remedies).

41. *Consumers Union of US, Inc. v. States*, 5 N.Y.3d 327, 360, 806 N.Y.S.2d 99, 118, 840 N.E.2d 68, 87 (2005) (suggesting that the business judgment rule would operate in a nonprofit context as well to bar judicial inquiry when good faith and judgment is used in making a business decision); *see Spitzer v. Grasso*, 11 N.Y.3d 64, 71, 862 N.Y.S.2d 828, 832, 893 N.E.2d 105, 109 (2008); *Macnish-Lenox v. Simpson*, 17 Misc. 3d 1118(A), 851 N.Y.S.2d 64, *12-15 (Sup. Ct., Kings Co. 2007).

42. NPCL § 514. The directors must exercise the standard of care required under NPCL § 717 when delegating investment authority. NPCL § 514(b).

43. EPTL 11-1.7 (providing that it is contrary to public policy to limit a fiduciary's liability for "failure to exercise reasonable care, diligence and prudence").

44. EPTL 11-2.3.

45. EPTL 11-2.3(b)(2).

46. EPTL 11-2.3(c)(1).

47. *See In re HSBC Bank USA, N.A.*, 30 Misc. 3d 1201(A), 958 N.Y.S.2d 646 (Sur. Ct., Erie Co. 2010), *aff'd as modified*, 96 A.D.3d 1655, 947 N.Y.S.2d 288 (4th Dep't 2012) (finding a trustee negligent for purchasing "improper" investments at the direction of a non-trustee).

48. *Compare* NPCL § 723(a), *and* NPCL § 721, *with* EPTL 11-1.7.

49. *See In re Estate of Schulman*, 165 A.D.2d 499, 502, 568 N.Y.S.2d 660, 662 (3d Dep't 1991) (holding that trustee standards, not the business judgment rule, applied to the trustee).

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Surrogate's Court Implications of Statutory Dissolution and Common Law Equitable Corporate Dissolution

By Gary E. Bashian

Family quarrels are bitter things. They don't go according to any rules. They're not like aches or wounds, they're more like splits in the skin that won't heal because there's not enough material.

—F. Scott Fitzgerald

Despite the countless proverbs, anecdotes, and tall tales about the dangers of mixing family and business, it should come as no surprise that closely held family corporations still make up one of the most commonplace business models in America today—and for good reason. The idea that members of a family with a common, or complimentary, skill set can join forces to not only make their fortune, but to build a better future for themselves and their children is an integral part of the American dream. In fact, much of the creation of the post-World War II, modern, middle-class economy can be best understood by listening to stories of the once young entrepreneurs who sat long into the night at a kitchen table with their fathers, mothers, brothers, sisters, and cousins, and built the businesses that they still own and work to this day.

However, as all attorneys know far too well, even the best laid plans, noblest of intentions, and unshakeable relationships, can not only deteriorate, but explode given the right—or perhaps wrong—set of circumstances.

Far from immune to this problem, which all businesses face to one degree or another, closely held family corporations tend to be more susceptible to the types of internal struggles that can cripple a company, and potentially destroy what its founders worked so hard to create.

In most cases, these latent, sometimes overt, tensions and competing interests erupt with exceptional force when a closely held family corporation suffers the death of a family member whose testamentary plan results in a "shake-up" in ownership by the passing of business interests to one or more children. Usually, such a "shake-up" occurs when a last surviving parent dies, and the surviving children and/or extended family included in the decedent's testamentary plan find themselves as new, or newly empowered, shareholders.

Some beneficiaries might suddenly find themselves majority or super-majority stockholders in the family company. Typically, these beneficiaries will ensure that they enjoy all of the benefits their majority ownership affords. They will not only have a controlling interest in the company, managing its day-to-day operations as they see fit, but often will be elected (if they do not hold the position(s) already) as officers, directors, and/or board members—further and formally solidifying their authority. Notwithstanding the managerial powers that positions such as these impart (not least of which include the power to rubber stamp one's own business plans, declare dividends, hire and fire, etc.), overwhelmingly these positions also carry with them a variety of perquisites—such as company-financed vehicles, expense accounts, bonuses, memberships, extended health benefits, retirement packages, and the like.

Conversely, other beneficiaries might not be so lucky, becoming or remaining minority shareholders under the decedent's testamentary plan, and left to wonder what benefits they can expect from their minority interest. Indeed, minority shareholders may find themselves owners of stock in a profitable company, but without any return from their interests, unable to sell their shares to an outside investor, and faced with paltry offers from the majority shareholders who shrewdly refuse to offer even book value for the stock, knowing that the minority shareholder can realistically sell to no one else.

Friction between shareholders, officers, and directors in any corporation is an all too common problem. However, when there are the added elements of family dynamics coupled with an imbalance in the powers afforded the family members by virtue of their ownership interests and roles in the company, the situation can deteriorate quickly, and result in a fallout that causes suffering to the individuals involved, and the company itself.

Where there are family members vested with corporate power, and others left powerless, the result is almost always exacerbated tensions between the beneficiary shareholders. In these situations, minority shareholders will often approach counsel with a multitude of questions about their newfound status, and what options they have for becoming involved in the company. Often they will ask whether they can force a dividend; be able to obtain employment with the company for themselves, their spouses, and/or their children; have any say in how the company is operated; or whether

they can even sell their stock—specifically wanting to find out what their ownership interest means for them in terms of "dollars and cents." The answers to these questions will of course depend on the operational nature of the company itself, and how the majority treats the minority owners; but in most cases, the minority is less than pleased with the actions of the majority.

That being said, minority shareholders, especially those with non-voting stock interests, do have a few options if they have been summarily "frozen out" by the majority and rendered powerless—even though their stock ownership grants them few, or none, of the rights and benefits they might expect.

Critically, no matter how powerful or entrenched the majority shareholders, by virtue of their ownership interests gained by inheritance or otherwise, if they are officers, directors, board members, or simply the controlling interest of the company, they owe an unwavering fiduciary duty to the corporation itself, and by extension, to the minority shareholders. This fiduciary duty requires that they "treat all shareholders fairly and equally…preserve corporate assets, and…fulfill their responsibilities of corporate management with 'scrupulous good faith.'"[1]

Indeed, much like the duties of a fiduciary to a Trust and / or an Estate (and probably in contradiction to much of the public's perception of corporate governance), one of the fundamental principles of corporate law is that the management owes an absolute fiduciary duty of loyalty to the corporation.

Perhaps the most fundamental part of this duty is to ensure the rights of the minority, and to take no action that will directly or indirectly harm them or the company. In practical terms, this means that the majority must not only abstain from illegal or fraudulent acts,[2] but avoid "oppressive conduct" that would deny the minority shareholders some return on their ownership interest; not just any return, but one that is in line with the minority shareholders' (objectively) reasonable expectations of what that ownership interest should convey under the circumstances.[3]

Where the majority wrongfully and intentionally denies the minority this return; engages in fraudulent, illegal, or "oppressive acts"; perpetuates the corporation's existence for their own benefit; engages in the looting of corporate assets; artificially depress the value of the company; and / or engages in gross mismanagement of the company, their fiduciary duty is deemed breached, and the minority is empowered to seek the judicial dissolution of the company in order to secure their rights, and preserve their investment.[4]

Depending on their status, minority shareholders in New York can petition for a judicial dissolution by one of two means: (i) pursuant to statute under Business Corporations Law ("BCL") § 1104-a, or, (ii) under the common law.[5]

As implied above, a closely held corporation is just that, an entity that is owned and operated by a close knit group, usually family members, who have a common interest and purpose for the company, and where the majority shareholders are also the corporate officers and / or board members. Almost invariably, this leads to a concentration of power and decision making in the hands of a very few, and often to the detriment of the minority interests.

In practical terms, minority shareholders can be owners of a company in name alone as they frequently will have no voting rights; not be issued a dividend; have no opportunity to become an employee, manager, and / or officer; and are treated with little more than disdain by those in the majority. Meanwhile, the majority shareholder / officers of these companies frequently take full advantage of the benefits of their position, i.e., determining the terms of their own compensation; issuing themselves bonuses independent of corporate performance or profitability; granting themselves and immediate family extended health care benefits and many expense-related perquisites; granting themselves bonuses at will each year; having employment agreements providing for them and their spouses for years and years guaranteeing them future earnings; and using their powers to hire, fire, and hand-select members of the board and employees loyal to them.

Such actions can lead directly to the artificial devaluation of the company as a whole. The operational and investment capital available will be periodically depleted for the benefit of the majority, which in turn limits both financial and market growth and causes direct harm to the corporation and thus, the minority shareholders who receive no benefits. Such corporate devaluation and other such self-dealing that lead to the dilution of corporate funds and / or opportunity by the majority are firm grounds upon which to build a case seeking dissolution.

Although there is no established or bright line test to determine if judicial dissolution is appropriate, the courts have found that the following types of management practices can constitute a breach of fiduciary duty which will allow a judicial dissolution suit to proceed:

- where the majority has engaged in illegal or fraudulent actions;
- where the majority has carried on the company for the purpose of enriching themselves at the expense of the minority and / or the corporation;
- where the majority has engaged in self-dealing and / or waste, including excessive compensation and perquisites, conversion and / or looting of corporate assets, and / or causing the loss of corporate opportunity;

- where the majority has attempted to force the majority to sell their shares to them for below their reasonable value, especially where there is an intentional deflation or impairment of the stock for this purpose; and / or
- where the majority have prevented the minority from engaging in business activities, effectively freezing them out.

Although the grounds upon which judicial dissolution can be based are almost identical in either a BCL § 1104-a or common law proceeding for dissolution, the requirements of standing remain an important distinction. BCL § 1104-a proceedings are restricted to minority shareholders who own at least a 20% voting interest in all outstanding shares in the corporation. Unfortunately, at least for plaintiffs, more often than not this statutory requirement of 20% voting shares precludes them from bringing suit under the BCL.

However, at common law, an action for corporate dissolution still empowers a minority shareholder, regardless of percentage or voting interest in the company, to seek judicial dissolution on equitable grounds where the following can be established: (1) the majority has engaged in a "palpable breach of their fiduciary duties to the corporation" and / or (2) there has been "oppressive conduct" toward the minority, such as that listed above. While dissolution of a corporation on common law grounds is not frequently used or reported, courts have made clear that their equitable authority to force the breakup of a company is only warranted where the majority shareholder / officers are found to have breached their fiduciary duties to the minority. Given the common status of an estate beneficiary as a minority shareholder, a judicial dissolution proceeding at common law is often the only course available given the limited ownership interest.

Although dissolution may seem an extreme form of recourse to protect a minority interest, it is the only realistic way a minority shareholder may obtain a return on that interest. Minority shareholders cannot sell their interests on the open market for a reasonable return, they have no input in the manner in which the company can or will compensate them for their interest, and they are forced to silently watch as the majority continues to abuse corporate powers at the minority's expense. Short of forcing the break-up of the company, liquidating its assets, and redeeming their stock based on the liquidated value, minority stockholders really have no other option when confronted with an unreasonable and unyielding majority. This is especially so where one is made a shareholder by virtue of a bequest from a testamentary plan, as the majority, entrenched or not, frequently ignores the rights of the minority if they feel that a shareholder has not "earned" the right to have input in the way the company should be managed; believe that the shareholder does not have a truly vested interest in the company; or for reasons of personal animosity unrelated to the company itself, deny the minority shareholder his rights.

Helping clients obtain the best results possible is rarely easy, and often involves finding solutions in unexpected ways, up to and including the breakup of a company. Our firm has counseled clients in both the minority and the majority regarding matters such as these.

It is seldom an easy decision to enter into any litigation, certainly where the dismantling of a family company may be the result absent a settlement. Nonetheless, counsel to beneficiary shareholders should never disregard judicial dissolution as an option. It can be used as a powerful means of enforcing a client's rights, especially when there is no alternative. In situations where majority shareholders have been entrenched for years, have taken more and more of the net corporate income and have likely grown greedy and exercised "oppressive conduct," statutory or equitable dissolution is warranted. All too often when the founders of the business have passed away, the majority's impulse for greed takes over, and the minority has no other choice except to litigate.

Endnotes

1. *Matter of Kemp*, 64 N.Y.2d 63, 484 N.Y.S.2d 789 (1984).
2. *See generally In re Parveen*, 259 A.D.2d 389, 687 N.Y.S.2d 90 (1st Dep't 1999).
3. *See generally Brickman v. Brickman*, 253 A.D.2d 812, 677 N.Y.S.2d 600 (2d Dep't 1998); *In re Quail Aero Service, Inc.* 300 A.D.2d 800, 755 N.Y.S.2d 103 (3d Dep't 2002).
4. Often these same set of circumstances afford the shareholders the right to bring a concurrent Corporate Derivative Action as well on behalf of the company, but such an action is outside the scope of this article.
5. The authoritative cases on corporate Dissolution at Common Law in New York include: *Liebert v. Clapp*, 13 N.Y.2d 313, 247 N.Y.S.2d 102 (1963); *Matter of Kemp supra.*; *Kruger v. Gerth* 22 A.D.2d 916, 255 N.Y.S.2d 498 (2d Dep't 1964); *Fontheim v. Walker* 282 A.D. 373, 122 N.Y.S.2d 642 (1st Dep't 1953); *Lewis v. Jones* 107 A.D.2d 931, 483 N.Y.S.2d 868 (3d Dep't 1985).

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Cooperative Housing Corporations—Ownership by Trusts: A Retrospective and a Forecast

By Anita Rosenbloom and Eva Talel

Anita Rosenbloom

Every decade or so, we write an article discussing trends in trust ownership of cooperative apartments.[1] Trends are largely driven by changes (or feared ones) in the Federal estate, gift and generation-skipping tax laws. This article therefore addresses recent changes in the Federal estate, gift and generation-skipping taxes and their impact on requests to transfer ownership of cooperative apartments to a variety of estate planning trust vehicles, as well as how cooperative housing boards evaluate such requests. We hope that our insights will be helpful to both counsel to cooperative housing corporations and individual shareholders, and will facilitate such requests to symbiotically achieve the apartment owner's personal estate planning objectives while protecting the integrity of the cooperative housing corporation and its fiduciary obligations to all shareholders.

Overview of Changes in the Federal, Estate, Gift and Generation-Skipping Taxes

Our last article was written shortly after passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"),[2] when we noted an increase in the number of such transfer requests and forecast that the trend would continue. While we were correct in our forecast that there would be a steady increase in such requests under EGTRRA, what we did not fully predict was the magnitude of requests that would occur in 2011 and 2012 due to the fiscal cliff drama in Washington and dramatic shifts in the Federal estate, gift and generation-skipping tax laws.

Under EGTRRA, substantial increases in the Federal estate and generation-skipping ("GST") exemptions were phased in from 2002 until 2009, when they reached the $3,500,000 level. On January 1, 2002, the gift tax exemption increased to $1 million but remained frozen at that level. In 2010, the unthinkable happened when Congress failed to act and the sunset provisions of EGTRRA actually kicked in and the Federal estate and GST taxes were temporarily repealed in 2010. But the gift tax remained hale and hearty with a $1 million exemption and a 35% Federal tax rate.

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On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "2010 Tax Relief Act")[3] uniformly increasing the exemption amounts for Federal gift, estate and GST taxes to $5 million as of January 1, 2011 and decreasing all transfer tax rates to 35%. A surprising feature of the Act was the unification of the Federal estate and gift tax systems, with the gift tax exemption jumping from $1 million to $5 million. Essentially, the 2010 Act opened the floodgates on January 1, 2011 for wealthy couples to gift up to $10 million free of transfer taxes.

The exemptions for all three taxes—estate, gift and GST tax—were subject to further adjustments for inflation so that on January 1, 2012, the exemptions rose to $5,120,000 and the combined exemptions for a married couple became $10,240,000.

Unfortunately, to add further to the fiscal cliff drama, the 2010 Tax Relief Act had its own sunset provisions and on January 1, 2013, the Federal estate and gift tax exemptions were scheduled to drop to $1 million ($1,430,000 for the GST exemption) and the transfer rates were to skyrocket to 55%. It was this threat of a dramatic drop in the estate, gift and GST tax exemptions and spike in the transfer tax rates that fueled the flood of requests received by cooperative housing corporations for permission to transfer apartments to a variety of trusts before December 31, 2012, when the gates might close and eclipse the opportunity to make such transfers without the payment of transfer taxes. While there was a notable increase in such requests throughout 2011 and 2012, there was an avalanche of requests in November and December of 2012, when Congress came dangerously close to failing to act once again. Managing agents received requests down to the last few weeks in December, imploring cooperative housing corporations to consummate such transfers before January 1, 2013.

With 20/20 hindsight, we now know that on January 2, 2013 President Obama signed the American Taxpayer Relief Act of 2012 (ATRA),[4] which continued to unify the Federal estate, gift and GST exemptions

at the historically high level of $5 million, currently at $5,250,000 for an individual and $10,500,000 per couple as a result of further inflation indexing, and increased all transfer tax rates to 40%. Most individuals who secured the use of their exemptions by consummating gift transfers of their apartments on or before December 31, 2012 are pleased that they took such measures.

However, we heard of a few instances of "giftor's remorse," where individuals have regretted relinquishing control over their residence by transferring ownership to a trust. Some of these regrets related to the uncertainty regarding the availability of the NYC real property tax abatement to trusts discussed below—an uncertainty that many practitioners believe has since been put to rest by virtue of an amendment to the tax abatement law which makes certain trusts eligible for the abatement, coupled with clarification from the NYC Department of Finance ("DOF") that only one apartment owner need be eligible in order for the full tax abatement to be available to an otherwise qualifying apartment.[5]

Less than four months after President Obama signed ATRA, he released his 2014 budget proposal in which he proposes reinstating the estate, gift and GST tax parameters as they existed in 2009. The President's proposal would drop the current estate and GST exemptions from $5,250,000 to $3,500,000 and decrease the gift tax exemption from $5,250,000 to $1,000,000. The exemptions would no longer be indexed for inflation. Curiously, the President's proposal to reinstate the 2009 estate, gift and GST exemptions and tax rates would not be effective until 2018. The President's proposal would increase the rate for all transfer taxes from 40% to 45%. Portability of unused estate and gift exemptions between spouses would remain permanent.

Although it is difficult to assess the likelihood that the President's proposal will be enacted, the current estate and gift tax laws are only "permanent" if Congress enacts no new legislation. Numerous bills have been introduced, primarily by Republicans, to repeal the estate tax. Some proposed bills would continue the gift tax while others would repeal it as well. There currently is widespread speculation as to whether any "tax reform" can be enacted in the current political and economic environment. The uncertainty in Washington regarding the fate of the Federal estate, gift, and GST exemptions and transfer tax rates, coupled with an apparent rebound in the real estate markets, makes it likely that individuals who have not fully exhausted the use of their $5,250,000 ($10,500,000 per couple) exemption are likely to consider transferring ownership of their residences to a variety of trust vehicles. Cooperative housing corporations therefore can expect requests for permission to transfer residences to trusts to continue, but perhaps, barring unforeseeable developments in Washington, not at such-pent up levels as those experienced in 2011 and 2012.

There are countervailing factors that an individual will consider in deciding whether to transfer ownership of a residence to a trust in a gift transaction. For married couples, the permanent portability of the Federal estate / gift exemptions (but not the GST exemption) will take some pressure off of the need to use the exemption during an individual's lifetime. As of January 1, 2011, the Federal tax law introduced a new concept, "portability," allowing a surviving spouse to use a deceased spouse's unused estate (but not GST) exemption for lifetime gifts or upon death. Portability was made permanent under ATRA. Portability is not a panacea, however, as the GST exemption is not portable.

In addition, a major factor that an individual should carefully weigh in deciding whether to transfer a residence to a family trust, which is not includible in that individual's estate for estate tax purposes, is the loss of the step-up in income tax basis upon death. Of course, where an individual has a relatively high basis in the residence, this will not be a factor. But for those individuals with a low basis, the loss of the step-up should be carefully considered. Under current law, subject to certain limited exceptions, assets inherited from a decedent generally receive a "stepped-up" basis equal to the fair market value of the asset on the date of the decedent's death (or six-month anniversary of death if an alternate valuation date is elected). This step-up in basis would wipe out the taxable gain on any appreciation in the value of the residence that occurred prior to the decedent's death. In contrast, when an individual gifts a residence to a trust, the beneficiaries receive a carryover basis equal to the lesser of the donor's basis or the fair market value of the residence on the date of the gift (increased by any gift tax paid on any unrealized appreciation).[6] As a result, the built-in gain is passed along to the beneficiaries.[7] This factor is extremely important given the current convergence of the transfer and income tax rates as a result of ATRA.

While the estate tax rate is likely to be higher than the capital gains rate in the typical case, the spread between the federal estate tax rate and higher federal capital gains tax rate has narrowed. Under ATRA, the top Federal income tax rate on capital gains was increased by 33.3% (from 15% to 20%). As a result, there may be less of an incentive for making gifts of appreciated residences likely to be sold soon after death. In addition, there may be state and city capital gains taxes to contend with. Of course, the potential capital gain may not be of great concern if it is anticipated that the remainder beneficiaries of the trust will continue to own the residence for a lengthy period of time so that recognition of the gain is delayed, or that the beneficiary will

convert the residence to his or her principal residence (with the consent of the cooperative housing corporation) and hold it for the requisite period to qualify for the $250,000 exclusion of gain ($500,000 in the case of a married couple) in his or her own right. Simply put, for certain individuals it may no longer make sense to gift a low basis residence to a trust. A comparison of the potential estate tax savings versus income tax costs is essential before proceeding.

Another factor to be taken into account for residents of states such as New York, where there is no gift tax but an estate tax with an exemption well below the Federal exemption (i.e., $1 million), is that by gifting the residence, future New York estate tax on the fair market value of the residence (as of date-of-death or alternate valuation date) is eliminated.

Yet another consideration that is likely to influence an individual's decision to defer gifting one's residence to a family trust is simply the fact that there currently are no hard-wired sunset provisions in the Federal estate, gift and GST exemptions or tax rate. Therefore, time may not be of the essence in making this determination.

Some individuals may adopt the philosophy that it is better to be safe than sorry and will secure the use of their gift and GST exemptions which are currently at a historically high level of $5,250,000 ($10,500,000 per couple), particularly if the subject of the gift is a high basis residence. In some cases, individuals may try to leverage the use of their $5,250,000 exemptions by transferring a partial interest in a residence to one or more trusts and claiming a fractional interest discount, because such discounts may be eliminated by future legislation. However, as discussed below, some cooperative housing corporations will not favor consent to transfers of partial interests in cooperative apartments.

Cooperative housing corporations are structured so that the shares and proprietary lease for an apartment designate ownership and occupancy by a single family unit—either a single individual or spouses, and their immediate families. Divided or fractional ownership is inconsistent with this model and can result in disputes between those in occupancy and a fractional trust owner. The corporation may become embroiled in such disputes, thereby unnecessarily incurring legal fees and creating uncertainty as to occupancy rights and the like that may be created by the fractional ownership. An inherently risk-averse entity such is a cooperative housing corporation may not wish to subject itself and its shareholders to such cost and uncertainty.

Overview of More Common Types of Trusts and Trends in Transfer Requests

Historically, there were two types of trusts into which transfers were sought to be made: the grantor trust (also commonly referred to as a "revocable trust" or a "living trust") and the qualified personal residence trusts ("QPRT"). More recently, for reasons discussed below, QPRTs have become less popular and we have seen an increase in requests for apartments transfers to dynasty trusts (i.e., trusts which are intended to be exempt from the generation-skipping tax and which span multiple generations), as well as spousal lifetime access trusts known by the relatively new acronym "SLATs." We also have seen an increase in requests to purchase apartments by existing trusts of all different types. This is likely a result of the fact that it has become much more commonplace for residences to be owned by trusts and that cooperative housing corporations generally have become more accepting of trust ownership of apartments.

For grantor trusts, ATRA should have absolutely no impact on their popularity because these trusts are not designed to achieve any estate or gift tax savings. Typically, they are includible in the grantor's gross estate for estate tax purposes.[8] In contrast, as discussed below, the QPRT is a statutory creature of the Internal Revenue Code and generally the sole reason for establishing it is to attain gift and estate tax savings. Whether it makes sense for an individual to transfer a cooperative apartment to a QPRT in light of ATRA will depend upon an analysis of traditional factors such as the individual's age, state of health, available gift tax exemption, anticipated estate tax exemption, projected taxable estate, cost basis in the apartment, the value of the apartment and, most importantly, the individual's comfort level with parting with ownership. It also may depend upon her or his estate planning counsel's confidence in predicting whether there ultimately will be a reduction of the Federal estate, gift and GST exemptions as the President has proposed, or a permanent repeal of the Federal estate tax as Republican representatives have tried to achieve.

There are several reasons why QPRTs have become less popular. First, in low interest rate environments, the actuarial value of the remainder interest (which is the gift reported) is enhanced. As interest rates rise, the value of the remainder interest (i.e., the taxable gift) will decline so the impact of this factor may need to be revisited. However, the main reason why a QPRT may be unattractive is the loss of the step-up in income tax basis. As the Federal gift and estate tax transfer tax rate and income tax capital gains rate converge, it may no longer make sense to gift a low-basis residence to a QPRT. Once the transfer to a QPRT is made, it is not reversible. The QPRT Trust Agreement must contain a provision precluding the sale or transfer of the residence held in trust, directly or indirectly, to the grantor, the grantor's spouse or an entity controlled by the grantor or the grantor's spouse during the trust term, or at any time after the trust term that the trust is a grantor trust.[9] From a generation-skipping tax perspec-

tive, there is also another disadvantage. It is not permissible to allocate the generation-skipping tax exemption upon the creation of the QPRT. Under the Internal Revenue Code,[10] the Grantor cannot allocate his or her GST exemption to property transferred during the period for which the property would be includible in the grantor's estate, if he or she were to die immediately after the transfer. Because the trust assets are includible in the grantor's estate, if the grantor were to die during a retained term,[11] the grantor cannot make an effective allocation of the GST exemption until the retained interest by the grantor terminates at the then fair market value of the residence and other trust assets. For this reason, QPRTs are seldom used as a planning vehicle to maximize the use of an individual's GST exemption or to pass property to grandchildren.

From time to time, cooperative housing corporations receive requests for transfers of apartments to a testamentary trust under the Will of a deceased shareholder (typically to fund a credit shelter trust) or a request for a transfer to (or a purchase by) an existing trust established by a third party other than the intended resident. It is likely that these types of transfer requests will continue. Indeed, it is possible that there will be an increase in the number of requests to transfer cooperative apartments to credit shelter trusts under a deceased shareholder's Will, as the Federal estate tax exemption has now expanded to $5,250,000 and a larger portion of an estate will pass into these trusts, unless the individual decides to avail herself or himself of portability and forgo fully funding the credit shelter trust.

Because it is likely that cooperative housing corporations will continue to receive a steady stream of requests for apartment transfers to trusts, we will now discuss the ramifications of these transfers from the perspective of the corporation and with a view towards facilitating shareholder transfer requests where feasible.[12]

Role of Counsel

For those cooperative housing corporations which have not already been faced with the issue of trust ownership of an apartment, ideally they should seek the advice of counsel in advance of a trust transfer or purchase request in order to formulate a policy to deal with such requests and be prepared to address them when they are received. With or without a pre-existing general policy, when a board receives a request for an apartment transfer to or purchased by a trust, it should seek the advice of counsel in reviewing the particulars of the request. Counsel for the corporation should understand that the decision as to whether to permit a transfer to or purchase by a trust is within the discretion of the board. If a board is inclined to accommodate a request for a transfer to or purchase by a trust, the corporation's counsel should endeavor to ensure that the corporation is at no greater financial or other risk with a trust as a shareholder than it is with a natural person.

The first step in the process is review of the trust instrument itself.[13] It cannot be emphasized enough that each trust instrument—and this means the entire instrument, not just excerpts—must be reviewed by an attorney well-versed in trust issues. After review of the actual and complete trust instrument, the corporation's counsel should advise the board of the basic terms of the trust and any problematic provisions and should recommend documentation which may alleviate board concerns. Counsel should also consider and advise whether there is any legal impediment to a transfer to the trust. Ultimately, in the absence of a legal impediment, the final decision is within the discretion of the board.

Importantly, it should be made clear to the shareholder seeking the transfer or the trust entity purchaser that the fees of the cooperative housing corporation's counsel for review of the trust documents and advice to the board, as well as other fees in connection with the transfer, will be borne by the shareholder seeking the transfer, or the trust purchaser, regardless of whether the transfer or purchase is approved. Legal fees will vary dramatically depending on the complexity of the trust instrument and the extent of document modification and / or creation required to allay board concerns. Shareholders seeking to make trust transfers and / or trust purchasers should be made aware of this and their agreement to be responsible obtained before fees are incurred.

Grantor Trusts

A grantor trust is a revocable, amendable trust created primarily for the benefit of the shareholder / grantor during his or her lifetime. Often, assets other than a cooperative apartment will be transferred to a grantor trust. Typically, the income and principal of the trust may be freely used by the trustee for the grantor's benefit during the grantor's lifetime. The grantor trust is often used as a Will substitute, providing for the disposition of the trust assets upon the death of the grantor, but does not result in estate or gift tax benefits. There is a perception that the grantor trust permits the avoidance of probate proceedings, saves expenses and facilitates property transfers. However, these benefits may not actually materialize.[14] At a minimum, the grantor trust may be used to administer assets where the grantor becomes disabled or incapacitated. Because revocable grantor trusts are often used as a Will substitutes, they are generally governed by the law of the grantor's domicile. As a result, there can be significant differences between revocable grantor trusts governed by New York law and those governed by the laws of

other jurisdictions, such as California and other community property states, where the common practice is to have joint revocable trusts by spouses. This can greatly increase the complexity of the trust agreement. Often the dispositive provisions, and which spouse has authority to act with respect to revoking and amending the trust and withdrawing assets, may turn upon the classification of whether the apartment is community property. These issues must be dealt with when the apartment is sought to be transferred to or purchased by a trust, so that the cooperative corporation knows who has authority to act at any given time. The best way to handle such matters is to obtain a legal opinion letter addressing these issues from counsel to the Trustees admitted to practice in the state whose law governs the trust agreement.

In the case of the grantor trust, very little is likely to change in the occupancy of the cooperative apartment during the grantor's life. The grantor will continue to be the primary occupant and will not be obliged to pay rent to the trust, which often is necessary in the case of other types of trust vehicles where the grantor is attempting to achieve gift and estate tax savings. As a result, the concerns raised for a cooperative housing corporation by the grantor trust and the QPRT are somewhat different. For example, in the case of a QPRT, the grantor is likely to be alive at the termination of the trust, giving rise to issues of occupancy and control of the cooperative apartment. Further, virtually the only asset in a QPRT will be the cooperative apartment, while a grantor trust is usually funded with other assets. Despite these differences, the documentation recommended to allay the corporation's concerns raised by the grantor trust, the QPRT and most other common types of trusts are similar. In a transfer to a grantor trust, as with any transfer of a cooperative apartment to a non-individual, occupancy of the apartment should be controlled by an occupancy agreement. The occupancy agreement should also have the grantor of the trust, the Trustees and current beneficiaries confirm that no further transfer of the apartment from the trust, either during the grantor's lifetime or after his or her death will be permitted without board approval, even if the trust provides for the transfer to a named beneficiary of the trust. A personal guaranty by the grantor is advisable as a secondary source of funds for payment of maintenance and other charges, should the trustees fail to pay the same. Finally, the attorney opinion letter discussed below should be obtained.

QPRTs

The QPRT is a potentially effective estate planning device for an individual who owns a valuable residence. Final Treasury Regulations[15] setting out the requirements for this form of trust were issued in 1992. A QPRT is a form of trust which can be used to remove a residence from an individual's gross estate while making a taxable gift valued below that of the present market value of the residence. The residence may be a fee interest in a house, a condominium or a cooperative apartment, but it must be a personal residence of the grantor as defined in the applicable Treasury Regulations.

The QPRT plan generally works as follows: An individual transfers a personal residence into an irrevocable QPRT, retaining the right to use the residence for a fixed term, for example five years. The QPRT provides that upon the expiration of the term, the residence is to pass to designated beneficiaries or to a follow-on trust for such beneficiaries or others. The creation of the QPRT is a completed gift to the beneficiaries, but only in the amount of the current actuarial value of the remainder interest (as reduced by the grantor's contingent reversionary interest should he or she die during the trust term), which passes to the designated beneficiaries upon the expiration of the term for which the grantor has reserved the use of the residence. For example, if an individual 60 years of age transfers a residence worth $1,000,000 to a QPRT in September of 2013, retaining the use of the property for 10 years, the amount of the taxable gift would be approximately $700,460.[16] If the term of the QPRT is extended, the amount of the taxable gift is reduced. On the other hand, if the term is shortened, the amount of the taxable gift would be increased.[17] Note that for the QPRT to achieve estate tax savings, the grantor must survive the fixed term for which he or she retains the right to use the residence. If the grantor dies within the term of the QPRT, the entire QPRT (including the residence) would be includible in his or her taxable estate.

A QPRT is established under a trust agreement which is irrevocable (to accomplish its gift and estate tax objectives), although some QPRTs may grant the trustees a limited power to amend the QPRT to comply with requirements of the tax laws, as they may be amended. The QPRT is a form of grantor retained income trust, commonly referred to in estate planning circles by the acronym "GRIT." Thus, some of the transmittal documents provided to the cooperative housing corporation by the shareholder making the request to transfer a cooperative apartment may refer to the trust as a "GRIT." In almost all cases, however, the trust agreement is likely to make a reference to a "QPRT." Although most of the requests that cooperative housing corporations are likely to receive will involve a QPRT, not all GRITs are QPRTs. In certain limited circumstances, it is possible that the request will be to transfer an apartment to a GRIT which is not in the QPRT format. It should also be noted that while a QPRT may be a "grantor trust" for *income tax purposes* for a certain period of time, depending upon how the trust instrument is drafted, its provisions will be substantially different from the revocable form of grantor trusts discussed above.

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

1. The grantor (i.e., the shareholder) will reserve the right to use the apartment for a fixed term of years. Although the QPRT trust agreement may restrict occupancy to the grantor during the term for which he or she has reserved the use of the apartment, boards nevertheless should have an occupancy agreement executed by the grantor individually and the Trustees of the trust, confirming that the grantor and the grantor's immediate family will be the sole occupants of the apartment throughout the term of the trust.

2. The trust agreement should preclude the Trustees from holding assets other than the subject cooperative apartment and sufficient cash to meet six months of expenses for the apartment. While the trust agreement may permit the infusion of cash from time to time to cover six months of expenses, generally there will be no requirement that such moneys be added to the trust. Although not mandatory under the Treasury Regulations, many QPRTs may impose upon the grantor the obligation to meet all expenses relating to the apartment, such as maintenance and assessment charges due pursuant to the proprietary lease, and insurance premium costs. The fact that the residence is subject to a mortgage does not jeopardize the trust's status as a QPRT under the Treasury Regulations, but may impact the size of the initial taxable gift and have further gift tax implications when mortgage payments are made, depending upon whether the debt is recourse or nonrecourse.[18] Thus, in dealing with all QPRTs, it is incumbent on a cooperative housing corporation board to obtain a personal guaranty of the proprietary lease's obligations from the grantor, as there may be nominal funding of the trust other than with the residence itself.

3. As previously noted, the QPRT Trust Agreement must contain a provision precluding the sale or transfer of the residence to the grantor, the grantor's spouse or an entity controlled by the grantor or grantor's spouse during the trust term or at any time thereafter that the trust term is a grantor trust for income tax reporting purposes. This effectively precludes the grantor from swapping out a low basis residence before death in order to achieve a step-up in basis. This limitation does not apply to other forms of planning vehicles, such as dynasty trusts and SLATs, which may therefore be preferable vehicles in the case of low-basis residences.

4. Upon the expiration of the fixed term for which the grantor has reserved the use of the apartment, the trust principal (including the apartment) will pass to designated beneficiaries such as children, other family members or even non-family members. In some cases, the trust agreement will provide that the apartment passes outright to the children or other beneficiaries; in other cases it will provide that it passes into a "follow-on trust" for the particular beneficiaries. For example, it may pass into a combined discretionary trust for the grantor's issue and name a non-family trustee (who is not one of the grantor's issue) as the trustee. Some grantors feel that this gives them greater assurance that their children (or other beneficiaries) will not sell the apartment while they remain in residence and that the trustee will enter into a lease which will permit the grantor to continue to occupy the apartment after the expiration of the fixed term. If the grantor wishes to continue to occupy the apartment following the expiration of the fixed term, he or she will have to lease the apartment from the new owners at a fair market rent to avoid potentially adverse gift and estate tax consequences. This is another reason why it may be preferable for the residence to continue to be held in trust. If the follow-on trust is treated as owned entirely by the grantor for income tax purposes, the grantor should be able to rent the residence from the Trustees without generating taxable income. Regrettably, this important benefit of follow-on trusts which are intentionally income tax defective is frequently missed by less experienced estate planning counsel. As a practical matter, many cooperative housing corporations will insist that during the grantor's lifetime, the residence continue to be held in a follow-on trust for the remainder beneficiaries in order to avoid splintered ownership.

   If a board is willing to consent to the transfer of an apartment into a QPRT, it also must decide whether it is willing at the time of the initial application to consent to the subsequent transfer of the apartment to the grantor's children (or other beneficiaries) at the expiration of the fixed term. If a board is reluctant to pre-approve the transfer to the children (or other beneficiaries) as owners, it could limit its approval to the initial transfer of the apartment into the QPRT. While this may not fully accommodate the grantor's wishes, because the grantor may wish to continue to occupy the apartment at the expiration of the fixed term by entering into a lease or similar

arrangement with his or her children (or other beneficiaries) who will then become the new owners, such board pre-approval is rarely, if ever, given, although this is entirely a policy decision to be made by the board. A compromise might be to allow occupancy by the grantor but permit other occupancies without a change in ownership, such as permitting occupancy by the immediate family of the grantor who, by virtue of the relevant proprietary lease provisions, may be entitled to occupy an apartment.

Note that a board's refusal to pre-approve the transfer to the grantor's children (or other beneficiaries) may only delay the issue because, if the grantor survives the term of the QPRT and the apartment is not sold during the term, the board will most likely receive a request at the expiration of the term for approval of the transfer of the apartment to the beneficiaries. The likely board response will be that the apartment should be transferred to a follow-on trust.

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

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

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

7. As in the case of all proposed transfers of a co-operative apartment to a trust, it is advisable to obtain an opinion from the grantor's counsel, admitted to practice in the state the laws of which govern the trust, addressed to the co-op, to the effect that: (a) the copy of the trust agreement furnished to the co-op is a true and correct copy; (b) there have been no amendments to the trust agreement; (c) the trust is a valid and existing trust under the law of the particular state cited in the trust agreement; (d) the trustees named in the trust agreement are the current trustees of the trust; (e) these individuals, in their capacities as trustees, have full authority to execute the proprietary lease and assume all of the obligations thereunder, and to execute the occupancy agreement and letter agreement described above; and (f) the obligations under the proprietary lease which are being assumed by the trustees will be binding upon any successor trustees.

Spousal Lifetime Access Trusts

With the dramatic increase in the gift tax exemption to $5 million on January 1, 2011 (currently $5,250,000 with inflation indexing) and the threat that the gift tax exemption could dramatically recalibrate to $1 million on January 1, 2013, came the emergence of the spousal lifetime access trust. For those individuals who were not comfortable with limiting their access to gifted property, such as a residence, they could have access through the "back door" by making their spouse a beneficiary of the trust. This type of trust has now become fairly commonplace and is known as a spousal lifetime access trust or "SLAT." In many cases, the spouse will be a discretionary beneficiary as to both income and principal and there may be other current beneficiaries, such as children and more remote descendants.

In addition to the donor-spouse having indirect access to the use of the residence, there are other features which may make the SLAT a much more efficient planning vehicle than a QPRT. If the beneficiary-spouse is permitted to occupy the residence either because she has a mandatory income interest or because the Trustee simply exercises his or her discretion to permit such occupancy, it is fairly well settled that the donor-spouse can continue to occupy the residence with the beneficiary-spouse without triggering inclusion of the residence in the donor-spouse's gross estate, which would ordinarily occur under Section 2036 of the Internal Revenue Code, because of the retention of beneficial enjoyment. Instead, the co-occupancy of the residence by the donor-spouse is considered to be a natural aspect of the marital relationship.[19] For those individuals who do not relish the idea of having to pay a fair market rent to continue to occupy their apartment after completing a gift transfer, the SLAT may be the perfect solution. On the other hand, individuals who are more focused on maximizing the tax benefits of their plan will perceive the payment of rent as a way of making an additional tax free gift to the trust. Of course, the affordability of paying a fair market rent, which can be quite substantial in New York City, will be a factor to consider. If the Trustee rents the apartment to the donor-spouse for fair market rent, the rent will not be a taxable transaction because of the grantor trust status of the trust, and will enhance the benefits to the intended beneficiaries of the trust who may be children or more remote descendants. Another reason why a SLAT may be superior to a QPRT is that there is nothing to preclude the grantor from purchasing a low-basis residence from the trust during his or her lifetime in order to achieve a step-up in basis at death. QPRTs also have the mortality risk of the grantor dying during the initial term resulting in the inclusion of the residence in the grantor's gross estate, which does not exist with a SLAT. As previously mentioned, QPRTs are not as desirable in extremely low interest rate environments but this may change if interest rates rise. Finally, there is no bar to the grantor allocating GST exemption upon the creation of a SLAT as there is with a QPRT. It should be noted that one disadvantage of a SLAT, compared to other types of trusts to which gifts of a residence may be made such as a dynasty trust, is that it is generally not eligible for gift splitting.

A word of caution. While it is possible for spouses to create residential (or financial) SLATs for each other, care must be taken not to run afoul of the reciprocal trust doctrine. While a full discussion of this issue is beyond the scope of this article, it suffices to say that if the trusts which the spouses create for each other are so similar that the trusts leave each spouse in the same economic position, each spouse may be treated as having created the trust for his or her own benefit resulting in estate tax inclusion. There are ways to stay clear of this hazard, such as by creating the trusts at different times, designating different Trustees, giving the spouses different beneficial interests and most importantly, in the case of residential SLATs, by perhaps gifting interests in different residences. Unfortunately, in the race to consummate planning before December 31, 2012, less care may have been taken by some practitioners than ordinarily would be to avoid the application of the reciprocal trust doctrine and/the step transaction doctrine. Taking an apartment which is owned by a couple as tenancy by the entirety and dividing it into tenancy in common moments before creating reciprocal looking SLATs for each other may prove hazardous. In some egregious cases, one spouse hurriedly transferred ownership to his or her spouse who then created a trust for the original owner spouse. It remains to be seen how all of this will turn out. As discussed above, for some cooperative housing corporations, transfers creating divided ownership would not be permitted in any event.

Dynasty Trusts

These are trusts which are designed to be exempt from the generation-skipping tax for the maximum period permitted under the rule against perpetuities of the governing law jurisdiction or indefinitely (for now)[20] if the jurisdiction has abolished the rule against perpetuities. Dynasty trusts are generally created for children and more remote descendants and are intended to span several generations. There are many different varieties. Some will include a spouse as a discretionary beneficiary to have access indirectly to the residence gifted by the donor-spouse as described in our discussion about SLATs. Many of these trusts will be intentionally defective for income tax purposes. This is an important consideration. In addition to the perceived benefit of the grantor sparing the trust and its beneficiaries from income taxes during the grantor's life, this may be essential if the grantor is required to pay a fair market rent in order to prevent the inclu-

sion of the residence in his or her estate for estate tax purposes. By having the grantor treated as the owner of both the income and principal of the trust, there will be no tax consequence to the grantor paying rent. Typically, the plan will be for the grantor to allocate GST exemption up front upon the creation of the trust on a timely filed gift tax return to insulate the residence and other trust assets, and their appreciation from the GST tax, throughout the term of the trust.

Many individuals who feel uncomfortable gifting financial assets in the range of $5 million to children and more remote descendants may find it far more acceptable to gift a residence or fractional interest in a residence to a dynasty trust, particularly if the spouse is a beneficiary.

For more sophisticated plans, the grantor may wish to gift a fractional interest in the residence in order to claim valuation discounts. The cooperative corporation's tolerance for divided ownership will vary from board to board. Most boards will permit such ownership as long as there is a commitment that all future transfers of these interests are transferred as a unity and are subject to board approval at such time. However, as discussed above, some boards simply will not permit divided ownership. The obvious benefit of gifting a fractional interest is to claim a tenancy-in-common discount and to leverage the use of the donor's gift and GST exemptions. From time to time, individuals also will request permission to transfer a partial interest in an apartment to a QPRT or other trust vehicle to achieve similar discounts.

For even more sophisticated plans, from time to time a cooperative corporation will receive a request for permission to *sell* an apartment to an existing family trust—almost certainly a trust which is intentionally income tax defective. Under those scenarios, it will be necessary to review the cooperative corporation's operative documents to determine whether a flip tax or other charges will be imposed. It also would be prudent for counsel for the Trustees to determine whether there are any real estate transfer taxes which will be imposed in the case of a sale but that would not apply in a gift transaction. A sale is likely to be considered where the donor has previously exhausted the use of his or her gift and/or GST exemptions and wishes to leverage the exemptions by selling an interest (perhaps a fractional interest) in the residence to an existing trust. Another word of caution in structuring such sales—the general rule of thumb is that for the transaction to be respected as a sale by the taxing authorities there must be at least a 10% debt/equivalent ratio.

Testamentary Trusts and Trusts Created by Third Parties

In addition to what have become routine requests for transfers to grantor trusts, QPRTs, SLATs and Dynasty Trusts, from time to time a cooperative housing corporation may receive a request for a transfer to a trust created under the Will of a deceased shareholder, or a request for a transfer to, or a purchase by, an existing trust established by a party other than the intended resident. Generally, if the board's policy permits non-individual shareholders such as trusts to own an apartment, the proposed transferee should be reviewed by the board as it would review an individual transferee, including a review of financial stability. The trust instrument should be reviewed for troublesome issues, such as spendthrift provisions discussed below. Documentation similar to that recommended for other trusts previously discussed should be obtained.

Spendthrift Provisions

While each trust instrument must be examined for problematic provisions, one particular trust provision that boards should be aware of is a "spendthrift" provision which purports to protect the assets of the trust from the creditors of the beneficiary and/or grantor. If a spendthrift provision is valid in the jurisdiction governing the trust, it might preclude a cooperative housing corporation from seeking satisfaction of claims that it may have against the grantor of the trust (or any other beneficiary of the trust) out of the trust assets, such as claims arising out of a personal guaranty of the proprietary lease obligations. Spendthrift provisions are most common and most troublesome in the case of grantor trusts, because it is likely that the grantor will have transferred substantially all, or at least a significant portion, of his or her assets into the trust. However, in many jurisdictions, including New York, a spendthrift provision in a grantor trust would not be binding against the grantor's creditors.[21]

Regardless of whether, as a matter of law, a spendthrift provision is binding against the grantor's creditors, a board should be wary of permitting the transfer of an apartment to a trust which provides on its face that the shares and proprietary lease (as well as all other assets of the shareholder placed in the trust) would be beyond its reach should it seek to execute a judgment against the grantor or other beneficiaries, as the corporation would be on notice of the existence of these provisions. To alleviate the concerns raised by the presence of a spendthrift provision, it is recommended that either (1) the trust agreement be amended in such a manner as to confirm that the spendthrift provisions shall be of no force or effect against the corporation, and that any claim that it may have against the grantor, individually, or in his or her capacity as trustee, or against any other trustee, including but not limited to claims arising out of a default under the proprietary lease, may be asserted against and satisfied out of the trust assets; or (2) the attorney's opinion letter referred to above include a confirmation of the same. An amendment to the trust agreement would appear to be

preferable as it would afford the corporation the greatest protection and should be obtainable in the case of an amendable grantor trust. While amending a QPRT may be problematic, the spendthrift issue arises less frequently in QPRTs because the transfer of a cooperative apartment will be the sole reason for the QPRT and board approval will invariably be sought before the QPRT is created. Thus, any spendthrift provision can be deleted or revised at the drafting stage.

Conclusion

There appears to be no legally well-founded reason for a cooperative housing corporation's board to reject proposed transfers to most trusts which are created for routine estate planning purposes such as grantor trusts, QPRTs, dynasty trusts, SLATs, testamentary trusts or third-party trusts, provided that the particular trust instrument does not contain problematic provisions, appropriate collateral documentation (an occupancy agreement and financial guarantees) is obtained and the particular circumstances surrounding the proposed transfer do not otherwise raise independent concerns. The corporation can be adequately protected and most shareholder requests are motivated by a reasonable desire to facilitate estate planning.

Such transfers provide a substantial benefit to such shareholders. For example, what could be a more compelling set of circumstances than to permit the transfer of an apartment to a credit shelter trust under a Will for the benefit of a surviving spouse and / or other family members, when there are otherwise inadequate assets to fund such trust? Another appealing circumstance is where a request is made for the purchase of an apartment by a trust for the primary benefit of the intended resident which was created by a third party, such as a parent or grandparent. The trust (which is the proposed purchaser) may enjoy a tax-favored status, such as being exempt from the generation-skipping tax and insulated from estate tax on the death of the beneficiary, which benefits the shareholder's family.

Occasionally, a trust transfer request may be made for permission to transfer a cooperative apartment to an asset protection trust where one of the objectives is to place the trust assets (including the cooperative apartment) beyond the reach of the grantor's creditors. Such requests pose entirely different issues, ones which are beyond the scope of this article and should be reviewed with great caution by counsel to the board.

Sometimes, a board's refusal to consent to an estate-planning based trust transfer request may be due to its lack of familiarity with the various forms of trusts and how readily the corporation can be insulated from any financial or other risk that may arguably be posed by trust ownership. As the desirability of trust ownership of residences become more commonplace in estate plans, both for tax and non-tax reasons, and cooperative apartments increasingly represent a significant asset of shareholders' estates, we urge boards to consider transfer requests with an open mind. Although few in number, there are some buildings which still have an absolute policy against permitting trust ownership of apartments.[22] We encourage such boards to review their policy for the benefit of their shareholders.

In the end, the decision to permit a trust (or other non-natural person) to own cooperative apartments is a policy decision for boards. Some boards have determined that non-individual ownership of apartments is inconsistent with the basic cooperative housing principle of owner-occupancy.[23] Most proprietary leases are drafted presuming that a natural person is the lessee. Thus, they include provisions which do not make sense for non-individual ownership. For example, most proprietary leases restrict occupancy to the named lessee and his or her family; obviously, a trust lessee can have no family. Further, the corporation is arguably at greater risk of disputes when actual ownership and beneficial ownership are divided as between a trust, its trustees, its grantor and its beneficiaries. These concerns can be alleviated by the documentation we have discussed above. While the question may arise as to whether this documentation, which arguably modifies certain terms of a proprietary lease relating to occupancy and transfers, constitutes an amendment of the proprietary lease which is invalid without shareholder approval, no case law offers guidance on this issue. However, the board's absolute right to withhold consent from a proposed transfer—to a trust or otherwise—for any reason or for no reason likely implies the right to also impose conditions—such as an occupancy agreement and the like—to a trust transfer.

Boards of cooperative housing corporations, with the advice of counsel, should carefully consider all aspects of trust ownership and formulate a policy which is acceptable and appropriate for the building, balancing the accommodation of shareholders and the duty to serve the entity as a whole. In our experience, which has spanned over 30 years with approximately 200 buildings which have addressed this based on our advice, most buildings have permitted trust transfers. Importantly, those cooperatives that have allowed trust transfers to date have not, to our knowledge, encountered any problems resulting from trust ownership.

To ensure compliance with requirements imposed by the United States Treasury Department in Circular 230, we inform you that any tax advice contained in this article is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Endnotes

1. Richard Siegler & Anita Rosenbloom, *Cooperatives, Condominiums: Ownership by Trust*, NYSBA Trust and Estates Law Section Newsletter, Spring 1994; Richard Siegler & Anita Rosenbloom, *Housing Cooperatives: Ownership by Trusts*, NYSBA N.Y. Real Property Law Journal, Spring 2002, Vol. 30, No. 2.
2. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA), P.L. 107-16 (2001).
3. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act of 2010), P.L. 111-312.
4. The American Taxpayer Relief Act of 2012, Pub. L. No 112-240 (2012).
5. New York Real Property Tax Law § 467-a; Laws of New York 2013, Chapter 4. Available at: http://public.leginfo.state.ny.us under the hyperlink for Chapters. (last visited 10/15/2013); NYC Dept. of Finance Cooperative and Condominium Tax Abatement page available at: http://www.nyc.gov/html/dof/html/property/coop_condo_abatement.shtml; NYC Finance Cooperative/Condominium Tax Abatement Fact Sheet available at: http://www.nyc.gov/html/dof/downloads/pdf/faq/coop_condo_tax_abatement_faq.pdf (last visited 10/15/2013).
6. I.R.C. § 1015(d).
7. For trusts created prior to May 16, 1996, it was possible through a clever maneuver to shield the remainderman from the gain by having the grantor reacquire the residence from the QPRT just prior to expiration of the grantor's retained term. Under this "bait and switch" technique, the remainderman would receive cash or other assets. Further, if the grantor retained the residence until death, its basis would be stepped-up. The Internal Revenue Service responded by issuing Treasury Regulations, effective for trusts created after May 16, 1996, requiring that, in order to qualify as a QPRT, the trust instrument must prohibit the trust from selling or transferring the residence, directly or indirectly, to the grantor, the grantor's spouse or an entity controlled by the grantor or the grantor's spouse. Treas. Reg. §§ 25.2702-5(c)(9).
8. I.R.C. §§ 2036, 2038.
9. Treas. Reg. § 25-2702-5(b)(1) and § 25.2702-5(c)(9).
10. I.R.C. § 2642(f).
11. I.R.C. § 2036(a)(1).
12. The Tax Reform Act of 1986 amended I.R.C. § 216 to include in the definition of "tenant-stockholder," non-natural persons, including trusts, owning co-op shares," so that trust ownership of a cooperative apartment does not impair the corporation's tax status and its ability to pass-through to its shareholders their pro rata share of the mortgage interest and real estate taxes paid by the corporation. Richard Siegler, *Impact of Tax Reform on Co-op Housing*, N.Y.L.J., March 4, 1987, p. 1, col. 1.
13. Note that for various reasons, trusts are established under the laws of different states; just because the cooperative apartment is located in New York does not mean that the trust will be governed by New York law.
14. *See Should I Create a Revocable Inter Vivos Trust*?, 63 N.Y. St. B.J. 48 (Dec. 1991); *Revocable Trusts—A Contrarian's Viewpoint*, 68 N.Y. St. B.J. 34 (Feb. 1996).
15. Treas. Reg. § 25.2702-5(c).
16. If the transfer is made after September 30, 2013, the figures may vary. This is because the interest rate upon which the Internal Revenue Service's valuation tables are based fluctuate from month to month. The interest rate is equal to 120 percent of the average yield on Treasury obligations with maturities between three and nine years. This example further assumes that the grantor has reserved a contingent reversionary interest in the QPRT instrument providing that, if the grantor fails to survive the trust term, the residence will pass to his estate or as he may appoint by a general testamentary power of appointment. The value of the grantor's contingent reversionary interest reduces the value of the gift.
17. The amount of the taxable gift turns on five factors: (1) the interest rate used by the Internal Revenue Service in its valuation tables, (2) the value of the residence on the date of the gift, (3) the grantor's age, (4) the length of the trust term and (5) whether the grantor has reserved a contingent reversionary interest.
18. Treas. Reg. § 25.2702-5(c)(2)(ii). Note that shareholders with loans must generally obtain their lender's consent to a transfer to a trust.
19. *Gutchess v. Comm'r*, 46 TC 554 (1966), Acq, 1967-2 C.B. 1; *Union Planters National Bank, Executor v. U.S.*, 361 F.2d 662 (6th Cir. 1966). *See also*, Revenue Ruling 70-155; PLR 9735035; PLR 9827037; PLR 200240020.
20. Since the release of the 2011 Greenbook, the Obama administration has proposed limiting the term that a trust could be exempt from the generation-skipping tax to 90 years.
21. EPTL 7-3.1.
22. In the event that the cooperative housing corporation refuses to consent to the proposed transfer to a QPRT, the IRS has confirmed that it nevertheless may recognize the transfer for transfer tax purposes. PLR 9447036 (Aug. 29, 1994); PLR 9433016 (May 18,1994); PLR 9249014 (Sept. 4, 1992). In those cases, after the board disapproved the request for transfer to the QPRTs, the donor assigned beneficial title to the cooperative apartment's shares and the proprietary lease to the QPRT and undertook as nominee to hold legal title for the QPRT. We would not recommend this course of action as it would be a default under the proprietary lease.
23. Many proprietary leases provide that board consent is not required for a transfer of an apartment to the spouse of the shareholder and/or that board consent to a transfer to a financially responsible member of the shareholder's family may not unreasonably be withheld. This raises the issue of whether a transfer to or by a trust for the benefit of a grantor's spouse or other family member should be subject to the same relaxed consent provisions. In addition, most proprietary lease provisions imposing a flip tax are triggered by a sale and payment of consideration and do not expressly cover a gift transfer to a trust. Therefore, each flip tax provision should be reviewed. If a board wishes to amend the proprietary lease to impose a fee upon trust transfers, this generally requires shareholder approval by a super-majority (66%) of the outstanding shares.

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Recent New York State Decisions

By Ira M. Bloom and William P. LaPiana

Ira M. Bloom

ADOPTEDS

Adopted-out Child Is Discretionary Beneficiary of Great-grandparents' Trusts; Status as Remainder Person Not Ripe for Adjudication

The wills of husband and wife created testamentary trusts which after the death of the second spouse became separate trusts for their son and daughter who were the income beneficiary of their respective trusts and, along with their issue, were discretionary beneficiaries of principal. After the death of the son, part of the trust property continued in trust to pay income to his son (testators' grandson) for life, remainder to his issue and if none to the testators' issue. Grandson and his issue are discretionary beneficiaries of principal during grandson's life. Son has three children, two of them born before the death of the first of his grandparents to die. After the death of the second testator, one of son's children, testators' great-granddaughter, was adopted by her mother's husband, her parents having been divorced. In the course of proceedings for judicial settlement of the trustees' account, the question of the adopted-out great-granddaughter's status as a beneficiary was put before the court.

After determining that the question of the great-granddaughter's status is determined by New York law, although the adoption took place in Nevada, Surrogate Howe held that the exceptions for intra-family adoptions in DRL 117(2)(b) do not apply because the interests are created in the wills of the adopted-out person's great-grandparents. However, adoption does not impair or defeat rights that have vested before DRL 117(2) was enacted. *See* DRL 117(2)(d). Because the great-granddaughter's rights as a discretionary beneficiary of principal vested at the latest at the death of the second of the testators to die, Surrogate Howe held that she is a beneficiary of the trusts for her father and his issue. The question of whether she is a remainder person of the trusts, and therefore entitled to trust property on the termination of the trusts on her father's death, is not ripe for decision because its resolution depends on facts and circumstances present at his death. *Matter of Manufacturers and Traders Trust Company*, __ Misc.3d __ , 968 N.Y.S.2d 834 (Sur. Ct., Erie Co. 2013).

William P. LaPiana

FIDUCIARIES

Although Court Can Take into Account Trustee's Misconduct After Period for Which Commissions Sought, the Nature of the Misconduct Did Not Warrant Denial of Full Commissions

A co-trustee of four family trusts was removed for conduct that occurred primarily after 2005 and denied annual commissions from 2006 to the time of removal. The Surrogate, however, did approve the payment of commissions for the year 2005 to the extent of two-thirds of the statutory annual commissions (SCPA 2309(2)) and, agreeing with the report of the referee appointed in the matter, denied commissions for 2003 and 2004 because the co-trustee failed to provide competent evidence of value of the trusts for those years. The referee, however, had determined that the trustee should receive full commissions for 2005 because absent controlling New York precedent, trustee misconduct after the period for which commissions are sought cannot be taken into account in deciding whether to grant commissions for the preceding periods.

The Appellate Division affirmed the Surrogate, holding that New York law did not prevent taking subsequent misconduct in to account in calculating statutory commissions for previous periods, and the courts therefore have discretion to do so. In addition, it is well established that denying commissions should not be "in the nature of an additional penalty." Here, the Surrogate's order was appropriate because the trusts did not suffer significant losses due to the co-trustee's actions. *Matter of Gregory Stewart Trust*, 108 A.D.3d 461, 969 N.Y.S.2d 458 (1st Dep't 2013).

TRUSTS

Joint Revocable Trust Became Irrevocable on the Death of First Grantor to Die

Father and mother created a joint revocable trust, which, after the death of both spouses, allocated certain trust assets to their three children in fixed percentages. After father's death, mother executed an amendment to the trust changing the allocation of property to the

children and naming a different successor trustee. The amendment of the disposition provision decreased the gift of one of the children. That child began a proceeding to invalidate the amendment. The Surrogate invalidated the amendment as it applied to certain trust property but upheld it as to other trust property and as to the naming of a new successor trustee. The Appellate Division affirmed the validity of the amendment's change of successor trustee but found the attempt to change the dispositive provisions completely invalid.

The trust terms state that the trust is revocable and amendable by the "Grantor," and "reading the trust as a whole, the term in that particular context referred to the decedents together." The trust terms dealing with the appointment, removal, and replacement of successor trustees, however, did indeed authorize the surviving grantor to name a new successor trustee. The grant of a testamentary non-general power of appointment to mother by the trust terms does not validate the amendment because it was not a valid exercise of the testamentary power. *Matter of Stuart*, 107 A.D.3d 811, 967 N.Y.S.2d 114 (2d Dep't 2013).

WILLS

Disposition to Trust Not in Existence at Time of Execution of Will Fails

Decedent's will pours over the residuary estate to a lifetime trust created by the decedent. The will was executed on March 22, 2011 and the testator executed the trust agreement as creator of the trust on that date. The trustee, however, did not execute the trust agreement until March 29, 2011. Because incorporation by reference is not part of the law of New York, the only way to sustain the disposition to the trust is by application of EPTL 3-3.7 which authorizes testamentary additions to trusts. One of the requirements of the statute is that the trust be executed "in the manner provided by [EPTL] 7-1.17 prior to or contemporaneously with the execution of the will." EPTL 7-1.17(a) requires that every lifetime trust be in writing and be "executed and acknowledged by the person establishing such trust and, unless such person is the sole trustee, by at least one trustee thereof." Because the trustee did not execute the trust agreement until after the execution of the will, Surrogate McCarty held that the requirements of EPTL 3-3.7 were not met and the disposition to the trustee of the lifetime trust fails. *Matter of D'Elia*, 40 Misc. 3d 355, 964 N.Y.S.2d 877 (Sur. Ct., Nassau Co. 2013).

Oral Agreement by Grantor to Pay off Mortgage on Conveyed Property Is Valid Contract Whether or Not Mortgage Is Mentioned in Grantor's Will

Grandfather orally agreed to transfer an apartment building to two of his grandchildren, reserving a life estate to himself, in exchange for their agreement to perform all of tasks necessary to the management of the building and his promise to pay off any remaining mortgage on the property at his death. At the same time the deed was executed, grandfather executed a will which specifically provided for the payment of any remaining balance on the mortgage. Some years later, grandfather executed a new will which made no mention of the mortgage. Grandchildren presented a claim for payment of the mortgage to the grandfather's estate.

Surrogate Versaci held that a valid contract was created, that the grandchildren had performed their part of the bargain and were entitled to judgment on the basis of promissory estoppel. The will mentioning the mortgage was not itself the contract and its revocation did not end the grandfather's promise. In addition, EPTL 3-3.6, which overturns the common law rule of exoneration, is not relevant because the property is not part of the probate estate. *Matter of Hennel*, 40 Misc. 3d 547, 967 N.Y.S.2d 625 (Sur. Ct., Schenectady Co. 2013).

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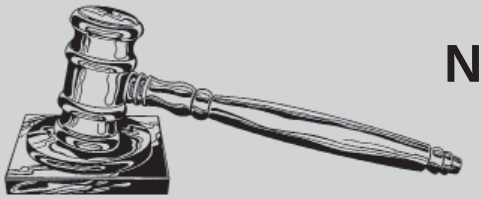

Case Notes— New York State Surrogate's and Supreme Court Decisions

By Ilene Sherwyn Cooper

Alterations to Will

Before the court was an uncontested application to admit a certain instrument to probate containing multiple handwritten alterations and interlineations. The instrument in its typed form left the decedent's entire estate to his wife, who was also the nominated fiduciary.

In reviewing the instrument the court noted that two of the alterations contained precatory language of no effect. Another alteration contained two lines through the name of the decedent's daughter, with the word "predeceased" written beneath, and another had the name of the decedent's daughter written in as an alternate residuary taker. Although none of the alterations were of consequence, the court was inclined to examine the Will for its genuineness before admitting it to probate.

The court opined that alterations made to a Will after its execution, which do not revoke the instrument, are to be given no effect. Moreover, because there is no presumption as to when an alteration is made, the court must look either to extrinsic evidence or intrinsic evidence for that purpose. Citing *Crosson v. Crosson*, 95 NY 145 (1884), the court noted that such intrinsic evidence may include handwriting, the color of the ink, and the manner of the interlineation.

The record before the court provided no extrinsic evidence of when the alterations were made. The attorney draftsman was deceased and none of the attesting witnesses to the instrument could be located. The instrument itself, however, revealed that while the changes that were made were in the decedent's handwriting, they were in blue ink rather than in the same black ink with which the instrument was signed. This fact, combined with other indicia in the instrument, caused the court to conclude that the alterations to the instrument had been made after it was signed.

Accordingly, the court admitted the instrument as originally prepared to probate.

In re Alston, N.Y.L.J., Aug. 1, 2013, p. 28, col. 4 (Sur. Ct., Queens Co.).

Attorneys' Fees

Before the court was an application brought by counsel for a beneficiary to have its legal fees fixed for services rendered to the beneficiary in connection with her interest in the estate of her late mother. The executor of the estate did not oppose the application provided that the fees were charged to the beneficiary's interest in the estate.

The record revealed that the services performed by counsel over a two-year period resulted in its client in receiving emergency and regular distributions from the estate, loans against her legacy, and personal property that she was unable to obtain previously. Since completing its work, counsel has not been able to contact its client and has not been paid.

The court noted that in a proceeding for the fixation of fees pursuant to SCPA 2110, the court is authorized to direct the source of payment either from the estate generally, or from the funds in the hands of the fiduciary belonging to the legatee. In examining this issue, the court relied on the factors outlined by the Court of Appeals in *Matter of Hyde*, 15 NY3d 186 (2010), that is (1) whether the objecting beneficiary acted solely in his or her own interest or in the common interest of the estate; (2) the possible benefits to the individual beneficiaries from the outcome of the underlying proceeding; (3) the extent of the individual beneficiary's participation in the proceeding; (4) the good or bad faith of the beneficiary; (5) whether there was justifiable doubt regarding the fiduciary's conduct; (6) the relative interest of the objecting beneficiary in the estate; and (7) the effect of allocating fees on the interest of the individual beneficiary.

Based on these criteria, the court concluded that in pursuing her claim against the fiduciary, the beneficiary was not seeking to benefit or enlarge the estate, but only to secure her legacy. The court determined that there was no possibility that the other beneficiaries of the estate would benefit from the legal services performed, and thus, that it would be unfair to assess the other beneficiaries with the fees incurred.

Accordingly, the court fixed the fees and disbursements of counsel and directed that they be paid from its client's share of the estate.

In re Frey, N.Y.L.J., July 25, 2013, p. 25, col. 5 (Sur. Ct., N.Y. Co.).

Business Judgment

In *In re LaVacca,* the administrator of the decedent's estate petitioned the Surrogate's Court, Dutchess County, for an order setting aside liens on a commercial parcel of property so that it could be sold, directing that the sale proceeds be retained after payment of closing costs and expenses, and directing payment of the debts of the estate upon the filing of his final accounting.

Upon consideration of the relief, the court declined to grant the fiduciary's application, concluding that the administrator was essentially requesting that it substitute its business judgment for his. Specifically, the court opined that in order for a petition for advice and direction to be entertained, extraordinary circumstances must be demonstrated. The court held that no such showing had been made, and that the provisions of EPTL 11-1.1 granted broad powers to the fiduciary that enabled him to administer the estate without court intervention.

In re LaVacca, N.Y.L.J., June 21, 2013, p. 42 (Sur. Ct., Dutchess Co.).

Eviction

In *In re Boyer,* it was held that the Surrogate's Court had jurisdiction over an eviction proceeding.

Before the Surrogate's Court was a request by the trustees of the testamentary trust under the decedent's Will for a final judgment of possession of specified premises, and the issuance of a warrant of eviction to remove respondent from possession. The record revealed that the Court had previously determined that the subject property belonged to the trust, and that the Will of the decedent conferred no proprietary interest in the property to the respondent, who was a trust beneficiary and a tenant at will.

On the issue of its jurisdiction over the subject of the proceeding, the Court held that it had the authority to direct an eviction of tenants from estate property, as it was a matter relating to the administration of a decedent's estate. The Court found the fact that the application was made by testamentary trustees, rather than an executor or administrator, was inconsequential inasmuch as the issues raised were intertwined with significant issues relating to the trust. Accordingly, the Court issued judgment in the petitioners' favor, concluding that the respondent had failed to submit competent evidence necessitating a plenary hearing.

In re Boyer, N.Y.L.J., June 14, 2013, p. 26, col. 6 (Sur. Ct., Dutchess Co.).

Laches

Before the court in *In re Tarka* was an uncontested motion by the Public Administrator, as fiduciary of the decedents' estates, for summary judgment dismissing the petitions of the respondent to set aside a stipulation of settlement and to vacate the accounting decrees entered in both matters, on the grounds of laches and failure of the petitioner to raise a triable issue of fact, or to demonstrate the merits of her underlying claims.

The record revealed that the decedents, husband and wife, died survived by their two children, one of whom was the respondent. Although initially the respondent had been appointed the executor of her mother's estate, she was subsequently removed due to her failure to comply with a court order directing her to account, and the Public Administrator was appointed in her place and stead. Upon the death of respondent's father, respondent's application to be appointed administrator of his estate was denied and the Public Administrator was appointed fiduciary, based on her failure to comply with the court's order in the estate of her mother, and the Appellate Division's affirmance of that order.

Subsequently, the Public Administrator and respondent entered a stipulation in open court whereby the parties agreed, *inter alia,* to the withdrawal of all pending appellate matters in both estates, withdrawal of objections by the respondent to the accounting of the Public Administrator in the estate of respondent's mother, the agreement by the respondent not to pursue objections to the account of the Public Administrator in the estate of her father, and withdrawal of claims by the Public Administrator against the respondent. The documents submitted by the Public Administrator in support of her motion established that she fulfilled the terms of the settlement with respondent, whereupon three years after it had been entered, respondent moved to set it aside.

In support of her application, respondent alleged that she had not been feeling well on the date she had entered the stipulation, and felt intimidated by the notion of having to proceed with a hearing in the event that she did not agree to the settlement.

In granting the motion by the Public Administrator for summary relief, the court opined that stipulations of settlement, especially those entered in open court, with the party seeking vacatur represented by counsel, are not lightly set aside. In order to succeed, a movant must establish grounds sufficient to invalidate a contract, such as new evidence, fraud, collusion, mistake or accident. An application to vacate a decree similarly will only be granted in extraordinary circumstances

based upon a showing of a reasonable excuse for failing to file timely objections, and a probability of success on the merits.

Nevertheless, the court concluded that even if respondent had demonstrated sufficient grounds to set aside the settlement and vacate the court's decrees, her claims would be barred by laches, as a result of her unexcused delay in instituting the proceedings and prejudice to the Public Administrator. In reaching this result, the court was persuaded by the fact that the respondent had been represented by counsel at the time she entered the stipulation, and she agreed to its terms with the advice of counsel after lengthy negotiations in which she participated. Further, the court found that respondent's claimed reasons for seeking vacatur of the stipulation and decrees did not establish a sufficient legal basis for doing so. Finally, the court noted that respondent provided no excuse for her lengthy delay, yet accepted all the benefits of her bargain to the detriment of the Public Administrator and the estate.

In re Tarka, N.Y.L.J., June 28, 2013, p. 38 (Sur. Ct., N.Y. Co.) (Surr. Anderson).

Notice of Election

In a probate proceeding, the surviving spouse of the decedent appealed from an order of the Surrogate's Court, Kings County (Lopez Torres, S.), which denied her petition for leave to file a late notice of election against the decedent's estate. The record revealed that the decedent had been married to the petitioner for 49 years prior to his death in November 2004. Preliminary letters testamentary issued on April 19, 2006 to the executor named in the decedents' Will, and on December 6, 2006, the surviving spouse served her notice of election on his attorney. However, the notice of election was not filed with the Surrogate's Court as required by the provisions of EPTL 5-1.1-A(d)(1).

The surviving spouse retained new counsel in October 2007, who discovered that her notice of election had not been filed in court in November 2008. Accordingly, in April, 2009, the surviving spouse filed a petition for leave to file a late notice of election pursuant to EPTL 5-1.1-A(d)(2). Letters testamentary were issued in May, 2009, and on October 26, 2011, the Surrogate's Court denied the surviving spouse's application.

In reversing the Order of the Surrogate's Court, the Appellate Division held that the surviving spouse had demonstrated reasonable cause for her failure to timely file her notice of election, by establishing that it was attributable to law office failure. In addition, she established that her late filing would not prejudice any party. Accordingly, the Court held that the Surrogate's Court improvidently exercised its discretion in denying the application.

Matter of Sylvester, 107 A.D.3d 903, 968 N.Y.S.2d 528 (2d Dep't 2013).

Notice of Election

The executor of the estate moved for summary judgment finding that the respondent failed to serve a notice of election during her lifetime, and that her right of election died with her. The executor of the wife's estate cross-moved to extend her right to file the notice.

The record revealed that the decedent's wife postdeceased him, and for the five year period between his death and hers she did nothing to follow the procedures for asserting her right of election pursuant to EPTL 5-1.1A (d). Although the surviving spouse claimed a right of election in her objections to probate of the decedent's Will, the Court held this was insufficient for purposes of satisfying the statutory requirements of the elective share statute. Moreover, the Court held that because the right of election was personal to a surviving spouse, any relief from a default in timely filing the notice of election was not available to her estate.

Accordingly, the executor's motion for summary judgment was granted.

In re Cyngiel, N.Y.L.J., July 30, 2013, p. 27 (Sur. Ct., Kings Co.).

Retaining Lien

In a contested probate proceeding, application was made by counsel for the objectants to withdraw, due to a conflict of interest among its clients, the failure of its clients to cooperate, and significant fees owing to the firm. Counsel also requested that it be granted a retaining lien for all property, documents, monies or securities belonging to its clients in its possession, until its legal fees were paid in full, as well as a charging lien.

In view of the fact that the application was unopposed, the firm's request to be relieved as counsel was granted. The court further granted counsel's request for a charging lien, but denied the firm's request for a retaining lien. The court held that a retaining lien is confined to property in the possession of an attorney and is entirely distinct from the lien of an attorney created by Judiciary Law §475. Specifically, the court noted that a statutory lien, as compared to a retaining lien, could be enforced by an order of the court, directing that it be satisfied out of moneys or property to which the lien attached though not in the possession or control of the attorney. As such, the retaining lien sought by counsel, being a possessory right only, could not form the subject of a court order.

On the other hand, the court found that a charging lien was available to counsel, but that the firm had

failed to submit any proof in the form of a retainer agreement, time records or an affirmation of services for the fees alleged to be owing. The court opined that when an attorney engaged under a contract for a definite purpose and not under a general retainer is discharged, such attorney is entitled to recover in quantum meruit the fair and reasonable value of the services rendered. Accordingly, while the court granted counsel a charging lien, it ordered that the amount of such lien would be determined in a separate application, pursuant to SCPA 2110, or in an appropriate action in another court for payment of its fees for services rendered.

In re Galfano, N.Y.L.J., July 19, 2013, p.33 (Sur. Ct., Suffolk Co.).

Three Year/Two Year Rule

In a contested probate proceeding, an application was filed with the Surrogate's Court, New York County by the objectant, who requested that the scope of discovery be extended beyond the three year/two year period set forth in Uniform Court Rule 207.27, and the court's discovery order. Specifically, the objectant sought expansion of the rule in connection with the examinations before trial of four witnesses, the decedent's prior physician, the decedent's former employer, the decedent's prior attorney and draftsman of three prior Wills, and the decedent's companion. The objectant alleged that a broader discovery period was needed in order to prove her claims of lack of testamentary capacity and undue influence by the decedent's companion over the course of many years.

In denying the relief requested by the objectant, the court held that deviation from the three year/two year rule would only be allowed upon a showing of special circumstances, based upon facts evidencing a scheme to defraud or a continuing course of conduct of undue influence. The court found that the objectant had failed to make such a showing, and that at most, the facts proffered demonstrated a long-term relationship between decedent and his companion. In addition, the court noted that medical records for the period covered by the rule and the examinations of the decedent's prior physician, his prior counsel and his companion were available to the objectant to explore her claim of lack of capacity and undue influence.

In re Macguigan, N.Y.L.J., July 3, 2013, p. 22, col. 3 (Sur. Ct., N.Y. Co.) (Surr. Mella).

Settlement Agreement

Before the Appellate Division, Second Department was the issue of whether an e-mail message could satisfy the criteria of CPLR 2104 so as to constitute a binding and enforceable stipulation of settlement.

The question arose within the context of litigation involving a multi-vehicle automobile accident. While motions for summary judgment were pending, settlement discussions ensued, and an offer by some of the defendants was orally accepted by the plaintiffs. That same day, a claims adjuster on behalf of said defendants confirmed the oral understanding in an e-mail to the plaintiffs' counsel. Thereafter, plaintiffs signed a release in favor of the settling defendants in exchange for the agreed-upon sum. Approximately 6 days later the court issued a decision granting summary judgment in favor of the settling defendants and dismissing plaintiffs' claims and cross-claims as against them. In addition, the decision granted plaintiffs' cross-motion for summary relief with respect to the liability of the remaining defendants. In response thereto, counsel for the settling defendants rejected plaintiffs' release and stipulation of discontinuance, claiming that there had been no settlement between the parties in accordance with CPLR 2104, and that the matter had been dismissed pursuant to the court's decision.

Plaintiffs then moved to vacate the court's order granting summary judgment and to enforce the settlement agreement between the parties as reflected in the e-mail exchange. The Supreme Court granted the application, and the defendants appealed.

In affirming the Order of the Supreme Court, the Appellate Division opined that in order to be enforceable, a stipulation of settlement must be in writing and subscribed by the party to be charged or his counsel. To this extent, the Court found that the e-mail message from the claims adjuster on behalf of the defendants set forth the material terms of the agreement between the parties. The Court rejected the defendants' argument that the agreement by the claims adjuster was insufficient to bind them, holding that as the agent of the insureds with either actual or apparent authority, the adjuster could bind the defendants to its settlement negotiations with the plaintiffs.

Moreover, the Court noted that traditional correspondence between parties has long been recognized as a basis for finding an enforceable stipulation of settlement under CPLR 2104. While the Court acknowledged that e-mail messages, as compared to letters, cannot be signed in the usual sense of the word, it recognized that Appellate Courts in the First and Third Departments have concluded that e-mail messages, which are otherwise valid as a stipulation between the parties, can be enforced pursuant to CPLR 2104. Indeed, given the widespread use of e-mails as a form of written communication, the Court opined that it would be unreasonable to reach a contrary result. Lending to this conclusion was the fact that in her e-mail message the claims adjuster added her name to the conclusion of the e-mail message, rather than resting content with

having her name automatically generated. This, in combination with the circumstances surrounding the e-mail, caused the Court to find that the claims adjuster intended to subscribe the e-mail settlement for purposes of CPLR 2104.

Accordingly, the Court held that where an e-mail message contains all material terms of a settlement and a manifestation of mutual accord, and the party to be charged, or his or her agent, types his or her name under circumstances manifesting an intent that the name be treated as a signature, such an e-mail message may be deemed a subscribed writing within the meaning of CPLR 2104 so as to constitute an enforceable agreement.

Forcelli v. Gelco Corporation, N.Y.L.J., July 26, 2013, p. 23, col. 6 (App. Div. 2d Dep't).

Ilene S. Cooper, Esq. is a partner at Farrell Fritz, P.C., Uniondale, New York.

Florida Update

By David Pratt and Jonathan Galler

David Pratt

Legislative Update

Florida has enacted new legislation addressing a variety of trust and probate issues. Summarized below are some notable changes in the law.

***Trust Accountings*:** Florida law provides that the trustee of an irrevocable trust must provide a trust accounting to each qualified beneficiary annually. Florida Statutes § 736.0813 was revised to clarify that a trustee who provides accountings more frequently, such as on a monthly or quarterly basis, need not provide a second accounting covering the same period at the end of the annual period.

***Unclaimed Property and Trustees*:** Revised Florida Statutes §§ 717.112 and 717.101(24) and new Florida Statutes § 717.1125 address unclaimed property held by trustees being administered pursuant to the Florida Trust Code. The legislation shortens the time period that a trustee must hold the property before seeking to deliver the unclaimed funds to the state from a period of five years to a period of two years.

***Non-Resident Jurisdiction in Trust Litigation*:** New Florida Statutes § 736.0202(2) specifies eight actions of a trustee, trust beneficiary, or other person, whether or not a citizen or resident of Florida, that will subject the person to personal jurisdiction in Florida. Among those actions are: accepting trusteeship of a trust having its principal place of administration in Florida or moving the principal place of administration of a trust to Florida; serving as trustee of a trust having its principal place of administration in Florida or created by a settlor who was a resident of Florida at the time of creation of the trust; and accepting compensation or a distribution from a trust having its principal place of administration in Florida. In addition, new Florida Statutes § 736.02025 provides for service of process by commercial delivery service, or by any form of mail, requiring a signed receipt when a court action seeks only in rem or quasi in rem relief.

***Elimination of Requirement to File Florida Estate Tax Return*:** The Florida Constitution effectively prohibits a Florida estate tax, but, until recently, Florida Statutes § 198.13 nevertheless required that any estate of a decedent dying after December 31, 2012 would have to file a tax return with the Florida Department of Revenue. *See Senate Bill 492—Florida Analysis and Fiscal Impact*. The statute has been revised to eliminate the requirement that an estate file a tax return with the Florida Department of Revenue even for a decedent dying after December 31, 2012. The legislation was made effective, retroactively, as of January 1, 2013.

Jonathan Galler

Case Law Update

New York Creditor's Claim Against Ancillary Estate in Florida

A nursing home that was owed payment from the decedent filed a complaint against the personal representative of the decedent's estate in New York before the estate was opened. The personal representative did not open the estate until a few years later, at which point the nursing home filed a claim against the New York domiciliary estate. Later that year, the personal representative opened an ancillary estate in Florida to administer the disposition of the decedent's Florida home, and the nursing home filed a claim against the ancillary estate as well. The nursing home petitioned for an accounting of the ancillary estate and to transfer the ancillary estate's assets to the New York domiciliary estate. The trial court dismissed the petition on grounds that the claim against the ancillary estate was untimely under Florida's two-year non-claims statute. Fla. Stat. § 733.710. The appellate court reversed, holding that although the claim against the ancillary estate was time-barred, it was not up to the Florida trial court to determine whether the claim against the domiciliary estate was time-barred. For that reason, the assets were to be transferred to the New York domiciliary estate for the New York court to adjudicate the claim. For the same reason, the nursing home was deemed an interested party with the right to compel an accounting of the ancillary estate.

Staum v. Rubano, 2013 WL 4081055 (Fla. 4th DCA August 14, 2013) (not yet final).

Will Contest—Standing

Petitioner filed a petition to revoke the probate of the 2009 will of the decedent. Petitioner alleged that the decedent's 1983 will was the decedent's only valid

will. Florida's probate code provides that a petition to revoke probate of a will may be commenced by any interested person, including a beneficiary under a prior will. Fla. Stat. § 733.109. However, a petitioner is not deemed to be an interested person for purposes of standing to revoke probate if the decedent's previous and presumptively valid will does not include the petitioner as a beneficiary of the estate. It is, therefore, the burden of the petitioner to establish that a previous will that excludes the petitioner as a beneficiary is also invalid. In this case, the trial court dismissed the petition to revoke probate for lack of standing because the petitioner was not named as a beneficiary in the decedent's previous three wills. The appellate court reversed, holding that petitioner had sufficiently alleged that *all* wills executed after the 1983 will, in which she was named as a beneficiary, were invalid on grounds of undue influence, incapacity and insane delusion.

Gordon v. Kleinman, 2013 WL 4081027 (Fla. 4th DCA August 14, 2013) (not yet final).

Enforceability of Trust Provision Regarding Waiver of Elective Share

Upon the death of her husband, petitioner filed a declaratory judgment action challenging the enforceability of a provision in the decedent's trust. The trust provided that if petitioner makes a valid disclaimer of all of her interest in the QTIP trust created under a separate provision of the trust and also makes a valid waiver of her right to elect the elective share in the decedent's estate, she would instead receive $5 million outright and free of trust. Petitioner contended that this provision of the trust constituted an unlawful penalty clause by penalizing her to the tune of $5 million for taking her elective share. The trial and appellate courts both disagreed with petitioner. Florida law invalidates trust provisions that purport to penalize an interested person for contesting the trust instrument or for commencing other proceedings relating to a trust. Fla. Stat. § 736.1108. However, the courts held that the provision at issue was enforceable. Unlike a "no contest" clause, which undermines the strong public policy interest in allowing courts to determine a trust instrument's validity, the provision here did not undermine the purpose of the legal right forfeited (i.e., the elective share) because it simply provided an optional alternative devise to the beneficiary.

Dinkins v. Dinkins, 2013 WL 3834371 (Fla. 5th DCA July 26, 2013) (not yet final).

Undue Influence

Two of the decedent's daughters filed a lawsuit against their sister, who was named the personal representative of their mother's estate. Among other claims, petitioners contended that the personal representative had unduly influenced their mother to take certain financial accounts out of her estate by making them "pay on death" accounts or joint accounts with right of survivorship. The trial court agreed, but the appellate court reversed, concluding that there was insufficient evidence to support an inference of undue influence. In Florida, undue influence is presumed when a person with a confidential relationship with the testator was active in procuring the devise and is a substantial beneficiary thereof. The appellate court concluded that petitioners could not demonstrate that the personal representative was active in procuring the devise. Perhaps most interestingly, though, the appellate court also noted that "evidence merely that a parent and an adult child had a close relationship and that the younger person often assisted the parent with tasks is not enough to show undue influence. Where communications and assistance are consistent with a 'dutiful' adult child towards an aging parent, there is no presumption of undue influence."

Estate of Kester v. Rocco, 117 So. 3d 1196 (Fla. 1st DCA 2013).

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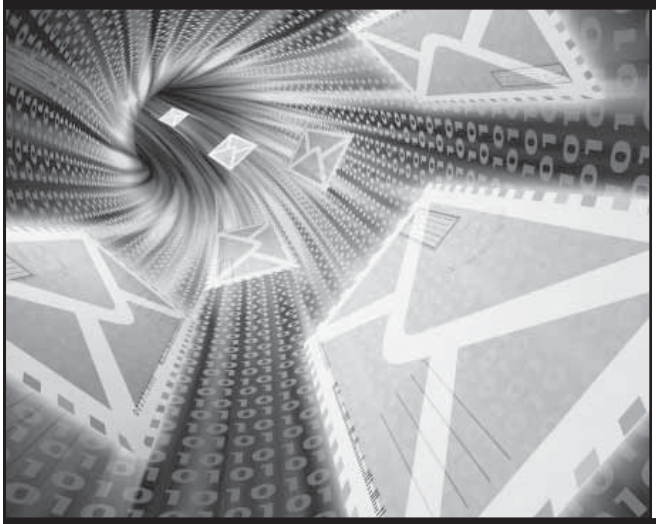

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