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ESTATE PLANNING AND ADMINISTRATION: THE COMPLETE GUIDE

MARSHALLING ASSETS AND DEALING WITH CREDITORS

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<u>DEALING WITH CREDITORS, NOTICES, APPORTIONMENT</u>

A debt of the decedent is an obligation of the deceased that was payable during his or her lifetime (see <u>In re Silvers' Estate</u>, 24 Misc. 2d 939, 201 NYS2d 415 (1960)). The Executor must pay claims that are just and owing to the creditor (see <u>In re Dimou's Estate</u>, 149 Misc. 83, 266 NYS717 (1933)). A creditor is "[a]ny person having a claim against a decedent or an estate (New York Surrogate's Court Procedure Act (the "SCPA") §103(11)).

Claims brought against an estate must be in writing, contain the facts and the amount of such claim and must be delivered personally to the executor or must be sent to the executor by certified mail return receipt requested (SCPA §1803). Claimants have seven months from the date that Letters Testamentary are issued to present the claim to the executor. If a claim is brought after the seven moth time period and the executor has distributed assets to the beneficiaries or paid other claims, then the executor is not responsible for the claim if no money is available to pay such claim (SCPA §1802). An executor may decide to pay bequests under a Will to the beneficiaries before the completion of the seven month time period (or the publication of notice to creditors if the Court requires it in the case of intestacy SCPA §805) if such executor retains sufficient assets to pay administration expenses, funeral expenses, debts of the decedent and taxes (New York Estates, Powers and Trusts Law (the "EPTL") §11-1.5). Actions can be brought in Supreme Court to resolve claims against the estate subject to SCPA §2106 with regard to persons under a disability such as a minor (EPTL §13-1.4).

If a creditor has a contingent or unliquidated claim against the decedent, then the claimant can file an affidavit with the executor showing the facts upon which the contingent claim is based and the probable amount of the claim. The executor shall hold an amount in reserve determined by the Court in a special proceeding or upon the final accounting. Once the contingent claim is due and payable, the reserve is used to pay the creditor and any amount in excess of the claim is distributed pursuant to the Will (SCPA §§§1804, 1916, 2217). If the claim becomes fixed before the final accounting is due,

then the claimant can file a claim in accordance with SCPA §1803 as previously discussed.

If the decedent owes the executor money, then such claim must be proved and allowed by the Court during the settlement of the executor's account. At any time before the accounting is due, the executor can file a petition with the Court requesting payment of the claim which the Court can grant with an ex parte order (SCPA §1805). The statute of limitations is suspended with regard to a debt of the decedent owed to the executor until the first accounting is filed. If the executor owes money to the decedent then the claim is included as an asset of the estate and the executor must repay it (SCPA §13-1.2).

The executor can reject the claim in a written notice providing the reasons for such rejection or upon inaction of the fiduciary, the claim is deemed to be rejected after the passing of ninety (90) days (SCPA §1806). The executor must list all rejected claims and why they were rejected in his final account. The issue of whether the claim is valid will be determined upon the judicial settlement of the executor's account (SCPA §1808). Additionally, the claimant may petition the Court to force the executor to show why the claim should not be allowed (SCPA §1809) or the claimant may bring an action at law or in equity within sixty days of receiving the notice of rejection (SCPA §1810).

If the executor allows a claim, the adversely affected parties in the estate have the right to file objections in a proceeding for the judicial settlement of account stating why "the claim was improperly allowed or fraudulently or negligently paid." A copy of the objections must be served on all parties. If the claimant has not appeared then a copy is served on him by personally or by mail. The Court can direct that the claimant repay the claim to the estate if the Court determines it should not have been paid in the first place (SCPA §1807). The Court can impose a surcharge on the executor if the Court determines that the estate was damaged by fraud, negligence or collusion.

If the executor believes that a claim may be filed but no such claim is presented to him or her, the executor may petition the Court to show why the claim should not be allowed (SCPA §1809). Additionally, a claimant may bring a petition requiring the executor to show cause why he or she should not be required to deliver claimed property

to the claimant (SCPA §2105). The Court will hear both sides of the issue and then determine who has an interest in such property.

Property subject to a special power of appointment or a general power of appointment exercisable only for the health, education, maintenance and support of the donee, is not subject to the claims of creditors (EPTL §10-7.1). All other property subject to a general power of appointment is subject to the claims of creditors (EPTL §10-7.2), including a general power which is not presently exercisable if the testator created the power in favor of himself or herself or if the power becomes exercisable (other than in the case of a testamentary power) (EPTL §10-7.4). A general power of appointment subject to a condition precedent or subsequent becomes subject to the claims of creditors when such condition occurs (EPTL §10-7.3).

A creditor may bring an action against the decedent's real property by filing a verified petition with the Court requesting that the property be sold. The executor can show cause why a decree granting such request should not be made. Process is served personally in this case (SCPA §1812). Real property may be disposed of to pay administration expenses, funeral expenses, debts of the decedent, taxes, payment of a legacy and payment to the persons entitled to payment (SCPA §1902). A proceeding to direct disposition of the real property is started by the executor or any other interested person filing a verified petition showing the facts of the case. All persons interested must be served. Any party to an accounting can also show why the disposition of the real property is desired (SCPA §1904). If the Court feels that the debt can be satisfied within a reasonable time using the rental income from the property, the Court can delay the disposition (SCPA §1905). Objections to the claims brought in the petition will be determined by the Court (SCPA §1906). The Court will issue an order with regard as to how the property shall be distributed (SCPA §1907) and if there is more than one piece of real property, the priority of sale is outlined in SCPA §1908.

The executor has the power to settle and adjust claims without Court approval (EPTL §11-1.1(b)(13)). Such settlements are honored unless the executor acting in bad faith or committed fraud (see In re Leopold, 259 NY 274, 181 NE 570 (1932), Scully v.

Scully, 201 NY 61, 94 NE 195 (1911)). Under SCPA §1813, the executor can obtain Court authorization for the settlement or adjustment by submitting an application setting forth the facts and reasons for the settlement. The use of this section would be appropriate when there are multiple executors acting and they disagree as to how the claim should be settled. However, the Court has discretion and cannot be forced to authorize the compromise and it cannot revise the settlement (see Levine v. Mellin, 81 AD2d 523, 434 NYS2d 355 (1980)). Under SCPA §2106, a fiduciary can bring a proceeding for authority to compromise a controversy between different claimants. All interested parties must execute the compromise agreement.

If the estate overpays a claim, then under SCPA §2215(3), the Court can direct repayment to the estate in the Decree issued following the judicial settlement of an account. The account must show the overpayment and give notice to the creditor.

An estate is insolvent if it does not have enough money in it or available to it to pay all of its funeral expenses, administration costs and debts of the decedent. When the decedent's estate is insufficient to pay its obligations, all of the property of a decedent is chargeable with the payment of administration expenses, funeral expenses, debts of the decedent, taxes and general dispositions (unless an asset is specifically bequeathed) (EPTL §13-1.3(a)). If there are insufficient assets in the estate to pay the creditor, then such creditor can attempt to recover the debt from the beneficiaries of the estate up to the value of assets distributed to them (EPTL §§12-1.1, 12-1.3). However, a creditor cannot reach a beneficiary entitled to receive payment from a pension, retirement plan, death benefit, stock bonus, profit-sharing plan or insurance proceeds (EPTL §§13-3.2, 13-3.3). The fact that the creditor did not present the claim to the executor does not bar such creditor's ability to recover from the beneficiaries (EPTL §12-2.1). Also, a creditor may reach a transfer on death ("TOD") account (EPTL §13-4.9).

If the Executor has not distributed the assets yet, then the bequests will abate in the following order to ensure sufficient funds to pay such estate obligations: 1) Distributees, 2) Residuary Beneficiaries, 3) General Beneficiaries, 4) Specific Beneficiaries and 5) spouse (EPTL §§12-1.2, 13-1.3). In general, if an estate is insolvent,

the beneficiaries will not inherit anything, even if a Will leaves them specific property or specified sums of money. Beneficiaries can only receive probate assets if there are assets left over after all debts and expenses have been paid. However, abatement does not apply to the payment of taxes. Such payments are covered by EPTL §2-1.8 which provides that the tax is equitably apportioned against among the persons interested in the estate unless the Will provides otherwise. Additionally, if the Will makes clear that the intention of the decedent is for property to be treated differently or that abatement shall proceed in a different manner, then the Will shall govern the payment of the debts and bequests (EPTL §13-1.3(e)).

Funeral expenses have first priority for payment of the decedent's debts followed by 1) debts entitled to a preference under the laws of the United States and the state of New York; 2) taxes assessed prior to death (however, a beneficiary of real estate under the Will must reimburse the estate for any real estate taxes paid by the estate on such real property unless the Will provides otherwise), 3) judgments docketed and decrees entered against the decedent, and 4) all other bonds, sealed instruments, notes, bills, etc. (SCPA §1811). All debts of each category must be paid in full before any debt of the next lower category may be paid. If there are not enough assets to pay all of the creditors in a particular category, then the creditors are paid on a pro rata basis. At that point, if there are lower categories of debt that remain, they will go unpaid.

Beneficiaries are not liable for the decedent’s debts nor are surviving relatives according to the Federal Trade Commission (the “FTC”). The rights of surviving relatives are covered by the Fair Debt Collection Practices Act (the “FDCPA”) which prohibits the use of abusive, unfair, or deceptive practices to collect debts (see “Debts and Deceased Relatives” at https://www.consumer.ftc.gov/articles/0081-debts-and-deceased-relatives). Problems with debt collectors should be reported to the New York State Attorney General's office and the FTC. In general, only the decedent’s assets can be used to satisfy the decedent’s obligations. However, if the creditor can prove there was a fraudulent conveyance of the decedent’s assets before the decedent’s death, then the recipient of those assets can be sued by the creditors.

SOLVING LIQUIDITY PROBLEMS

Life insurance is often used to ensure that an estate has enough liquidity to pay estate tax, mortgages, or looming expenses for the family such as college. Through use of an Irrevocable Life Insurance Trust (ILIT), insurance proceeds can be available immediately upon death which enables the trust beneficiaries to have use of the money while the Grantor's other assets are tied up during the probate process. Additionally, by keeping the insurance out of the Grantor's estate upon his death, the Grantor's estate saves estate taxes. Provisions can be included in an ILIT to allow for the Trust to purchase assets from the estate. The Executor will give the trust illiquid assets equal to cash received from the insurance proceeds. After that transaction, the estate has cash to pay its obligations and the trust has assets it can distribute the trust beneficiaries. This transaction can also be structured as a loan from the ILIT to the estate. For more details on ILITs, see Section V "Common Trust Structures and Their Consequences" in these materials.

The attorney should review all governing documents of a closely held business owned by the decedent such as articles of incorporation, bylaws and shareholders' agreement. Often times, a buy-sell agreement will require that the corporation own life insurance on the shareholder and will use the insurance proceeds to purchase the shares of a deceased shareholder. In this manner, the corporation retains control of the shares, avoids becoming partners with the decedent's family and provides liquidity to the decedent's estate to be used for paying estate expenses or providing much needed cash to the surviving family members. A methodology for setting the purchase price can be included in the agreement. Additionally, other provisions such as installment payments and deferred payments can be included.

Sometimes, there are no provisions for the entity to purchase the decedent's interest in the entity. 26 U.S.C.A. § 6166 provides an exception to the rule that estate taxes are due within nine months of the decedent's date of death in order to alleviate the burden of paying estate tax where at least 35% of the decedent's estate is an interest in a

closely-held business and therefore, does not have the necessary liquidity to pay the taxes. Without this law, the executor would need to sell the family business or farm in order to pay the tax. U.S. v. Askegard, D.Minn.2003, 291 F.Supp.2d 971; Snyder v. U.S., D.Md.1986, 630 F.Supp. 182. This closely held business is a sole proprietorship, or a partnership or corporation:

- with 45 or fewer owners; or
- in which the decedent owned an interest of 20% or more. "All stock and all partnership interests held by the decedent or by any member of his family (within the meaning of section 267(c)(4)) shall be treated as owned by the decedent." 26 U.S.C.A. § 6166.

Under IRC subsection (j) of section 6601, interest on the installment payments is charged at 2% on the tax attributable to the first $1,430,000 of the decedent's estate (see Rev. Proc. 2012-41.26). The estate must make the payments in at least two but not more than ten equal installments. The first payment is not due until the fifth anniversary of when the tax was initially due. However, interest is due during those first five years. Therefore, the total deferral result in 14 years. This election is only available to "the estate of a decedent who, at the date of death, was a United States citizen or resident." Rev. Proc. 98-15 Section 2.01(1).

. A distribution, sale, exchange, disposition, or withdrawal of at least 50% of the decedent's interest in the business will accelerate all unpaid tax. However, if the share redemption is in connection with paying for estate tax, funeral expenses, and administrative expenses, there will be no acceleration of the unpaid tax. If the business liquidates shares but uses the proceeds to further the business, no acceleration will occur. If instead, the business distributes the proceeds to the shareholders then acceleration will occur.

Another option is for the Executor to sell illiquid assets such as real property. Depending on market conditions and what the Will provides, selling the house soon after death could minimize capital gains due to a step up in basis and provide for needed cash flow. Alternatively, real estate can be used as collateral for the estate to borrow cash if

expenses must be paid and market conditions do not favor selling the real property so soon after death.

CLAIMING PORTABILITY ELECTION

As an alternative to planning using the Credit Shelter Trust or the Disclaimer Trust, beginning in 2011, a surviving spouse can make a portability election and use the Deceased Spousal Unused Exclusion ("DSUE") amount. The portability election is made on the deceased spouse's Form 706 United States Estate (and Generation-Skipping Transfer) Tax Return which includes a computation of the DSUE amount (Sections 302(a)(1) and 303(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296, 3302 (2010), Internal Revenue Code of 1986, as amended (the "Code" or "IRC") §2010(c)). IRC §2010(c)(2) defines the applicable exclusion amount as the sum of the basic exclusion amount ($5,000,000 adjusted for inflation IRC §2010(c)(3)) and, in the case of a surviving spouse, the DSUE amount. IRC §2010(c)(4) defines the DSUE amount as the lesser of (A) the basic exclusion amount or (B) the excess of the basic exclusion amount of the last deceased spouse of the surviving spouse over the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse. In 2017, the basic exclusion amount is $5,490,000.

For example, if a husband predeceases his wife and leaves everything to his wife, then before portability, he would forfeit his ability to give money to the next generation free of estate tax. The legislation changed that result, in effect giving the benefit of tax planning to those who may not have gone to an attorney or tax advisor. With portability, the unused federal estate exemption is "portable." In other words, upon her death, the wife's estate can use the husband's unused federal estate exemption. There would be no need for a Credit Shelter Trust or Disclaimer Trust in this example. Numbers rounded in example below for easier illustration.

Plan without Portability

Husband	Wife
$5,000,000	$ 5,000,000
Husband dies first and his $5,000,000 moves to Wife's column	$ 5,000,000 – no tax
	$10,000,000
Wife dies 2nd; unified credit (u.c.) is applied & amt passes to kids	($5,000,000) – no tax
Balance subject to NY and Federal estate tax	$5,000,000
Approximate combined tax rate 50%	($2,500,000) – tax
Balance passing to children	$ 2,500,000
Children receive	**$ 7,500,000**

Plan with Portability

Husband	Wife
$5,000,000	$ 5,000,000
Husband dies first and his $5,000,000 moves to Wife's column	$ 5,000,000 – no tax
	$10,000,000
Wife dies 2nd; unified credit (u.c.) is applied & amt passes to kids	($5,000,000) – no tax
Balance subject to NY and Federal estate tax	$5,000,000
Husband's u.c. applied using Portability & amt passes to kids	($5,000,000) – no tax
Balance subject to NY and Federal estate tax	$ 0
Children receive	**$10,000,000**

The illustration shows that the plan with portability results in more assets passing to the children and less estate tax being paid. However, there are some significant problems with "portability".

1. Although portability remains effective, we do not know how long this legislation will be extended.
2. Portability of the unused exemption is lost if the surviving spouse remarries and predeceases the new spouse. So, in the above hypothetical, if husband predeceases wife, wife could theoretically use husband's unused exemption when she dies. However, if wife remarries, that option may be lost.

3. Portability does not protect against appreciation in value. Again, in the above hypothetical, assume that husband predeceases and leaves everything to wife. Wife's estate is now over $5,490,000 but she can use husband's unused exemption assuming she does not remarry. Now, assume that wife outlives husband by 20 years and that on wife's death, husband's former assets have grown to $10,000,000. Husband's unused exemption will cover only $5,490,000, possibly leaving assets that would be subject to a federal estate tax. Had wife used his exemption with the use of a Credit Shelter Trust or Disclaimer Trust, the increased value would remain part of husband's estate and not be taxed on wife's death.

Plan with Portability and increase in value of assets

Husband	Wife
$5,000,000	$ 5,000,000
Husband dies first and his $5,000,000 moves to Wife's column	$ 5,000,000 – no tax
	$10,000,000
Many years pass and assets have grown	$15,000,000
Wife dies 2nd; unified credit (u.c.) is applied & amt passes to kids	($ 5,000,000) – no tax
Balance subject to NY and Federal estate tax	$10,000,000
Husband's u.c. applied using Portability & amt passes to kids	($ 5,000,000) – no tax
Balance subject to NY and Federal estate tax	$ 5,000,000
Approximate combined tax rate 50%	($ 2,500,000) – tax
Balance passing to children	$ 2,500,000
Children receive	**$12,500,000**

Plan with fully funded Disclaimer Trust or Credit Shelter Trust

Husband	Trust	Wife
$5,000,000		$ 5,000,000
Husband dies 1st u.c. applied	$5,000,000 - no tax	
Many years pass & assets grew	$10,000	
Wife dies 2nd; u.c. applied; goes to kids		($5,000,000) – no tax
Balance subject to NY and Federal estate tax		$ 0
Balance Trust pass to kids	$10,000,000 - no tax	
Children receive		**$ 15,000,000**

The illustration shows that through the use of the Trust, the appreciation escapes estate tax and more money passes to the children and less is paid in estate tax.

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