CONNECTICUT BAR ASSOCIATION

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VIEW FROM THE CHAIR
BY PETER T. MOTT

Kudos to Jim Funnell and George Smith, co-chairs of our newsletter subcommittee, along with all the members of that subcommittee and our various authors, for making this second newsletter of the year possible. We began the year with the goal of reviving the newsletter which had been dormant for a while and hope to get back to publishing two each year. As before, we encourage all the readers to consider submitting an article on a topic of his or her choice.

The CLE subcommittee continues to do a tremendous job. We have had three open Section meetings (two with national speakers and one with some of our "home grown" practitioners). John Ivimey conducted two seminars on the basics of Will and trusts drafting, we have co-sponsored a program at Yale Law School on Charitable Gift and Estate Planning, Frank Berall assembled a panel of speakers to address estate and tax planning for same sex couples and most recently Kelly Peck and Chris Drew organized a full day seminar on "How to Evaluate and Handle a Will Contest". At the CBA annual meeting in June, Laura Weintraub Beck and Doug Olin will discuss recent estate and retirement planning developments in a morning session, and then in an afternoon session, together with the Elder Law Section, there will be discussion on "the new Probate Court system". As we look toward the 2010–2011 year, we anticipate there will be more CLE on whatever estate tax changes finally emerge from Washington.

On the legislative front, some technical but very useful changes to the Uniform Principal and Income Act likely will be adopted in this session, dealing with deferred compensation plan payments to marital trusts and tax allocations on pass-through entity distributions. As of the date that I am writing this, we are continuing to pursue the adoption of the Uniform Adult Protective Proceedings Jurisdiction Act as well as monitoring probate court legislation, (most particularly a change in the statute that would clarify that out of state real estate is not part of the base for computing a probate court fee on a domiciliary estate, and that the only basis for the computation of a fee for ancillary administration is real property and tangible personal property located in Connecticut.) As we look ahead to next year, we will again consider moving forward with a proposal of adoption of the Uniform Trust Code in some form. We also will continue to monitor developments in Connecticut regarding the estate tax, and will do our best to address some of the more technical issues which vex many practitioners and taxpayers.

We look forward to furnishing you with another newsletter in the fall.

TRANSFER TAX APPORTIONMENT

BY BRYON HARMON
SHIPMAN & GOODWIN LLP

Wills and trust agreements are sophisticated, complicated documents. As estate planners, we spend much time and intellectual effort crafting formula funding, dispositive, fiduciary and other clauses on behalf of our clients. We may not spend as much time, however, on the tax apportionment clauses in our wills and trusts. Even worse, such clauses in a client's will and one or more trusts sometimes conflict or contradict one another. How big of a deal is it? For certain estates, it is not an overstatement to say that such clauses are the single most important provision in the estate planning documents -- and most likely to be either ignored or given only cursory review or examination.

Why are tax clauses (and apportionment generally) so important? Failure to include an appropriate tax clause due to oversight, overreliance on boilerplate provisions, inartful drafting or insufficient appreciation of the nature of assets can lead to disastrous consequences, including disinheritance of intended beneficiaries, increase of aggregate tax liability, and malpractice claims.

Although apportionment is concerned primarily with allocating the burden of a fixed amount of death taxes, it may also affect the amount of tax itself, not merely its allocation.

The modern prevalence of nonprobate dispositions as part of the sophisticated estate plan heightens the importance of addressing tax apportionment questions. In addition, the prevalent use of credit shelter trusts to decrease the overall transfer tax burden highlights the need to carefully plan for the payment of taxes, especially when the decedents' children are not all related.

To help the practitioner avoid the myriad traps and pitfalls, this article reviews and addresses the rules governing the allocation of the burden of transfer taxes among recipients of gratuitous transfers in wills and trusts. The goal is to impress upon the practitioner the importance of tax clauses, outline the relevant federal and Connecticut law, alert the planner to some common traps and issues and provide some insight on how to avoid such problems.

Notwithstanding the fact that wills and trust agreements often contain direction with respect to the payment of federal and state taxes, practitioners must learn and understand the complex web of federal and state apportionment law. Unfortunately, there is a relative absence of judicial and administrative guidance in this area and the planner is left with piecemeal statutes sometimes pointing the practitioner in different directions.

1. FEDERAL LAW - THE DEFAULT PROVISIONS

The Internal Revenue Code creates some limited federal tax reimbursement rules with respect to certain types of nonprobate assets includible in a decedent's estate. These are not apportionment rules, strictly speaking, but they do confer upon the executor the right to seek and obtain reimbursement from beneficiaries following the executor's payment of the tax. The Code guidelines differ from true apportionment rules in that they require the executor to pay the tax first.

One must note that "normal" tax apportionment by express direction in a will or trust is not pro rata but, rather, seeks to exempt certain dispositions from tax entirely by directing that tax shall be allocated as if the included property were not included, calculating the tax caused by its inclusion and expressly allocating this incremental tax, a result far different than pro rata allocation.

A. Right of Reimbursement. IRC Section 2205

To ensure that liability for the tax is clear, any recipient of nonprobate property who pays tax has a right of reimbursement from the estate. IRC §2205. Section 2205 also provides that, subject to a direction under the will of the decedent, taxes shall be paid out of the residue of the estate before its distribution.

NOTE: Intersection with State Apportionment Statutes

In Riggs v. Del Drago, 317 U.S. 95 (1942), the U.S. Supreme Court clarified that § 2205 does not preempt state law apportionment statutes by establishing a substantive right of reimbursement, nor is it intended to establish a federal rule of allocation of the tax to the residue. Rather, this section simply provides that payment of tax is to be made from the estate where a nonprobate beneficiary pays federal estate tax. As a result, § 2205

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applies only if the decedent's will does not express a contrary direction and state law does not direct some form of tax apportionment.

B. Reimbursement for Federal Estate Tax on Property Included under § 2042. Section 2206

Section 2206 grants the executor of an estate a right to recover estate tax from the recipients of life insurance proceeds includible in the gross estate under § 2042. The amount recoverable is pro rata. This means that the amount bears the same relation to the total tax paid as the proceeds received by the beneficiary bear to the taxable estate. To the extent a testator prefers to have insurance proceeds devolve to the beneficiary or beneficiaries free of federal estate tax, the right of recovery under § 2206 may be waived by a contrary direction in the decedent's will. Section 2206 does not require an express or specific reference to the statute or reimbursement right to waive reimbursement. A general direction in the will to pay all taxes from the residue will suffice.

Section 2206 contains an exception for insurance proceeds passing to a surviving spouse that qualify for the marital deduction. Such proceeds are not subject to the right of recovery for the payment of estate tax. (Note, however, that § 2206 provides no such exception for insurance proceeds subject to the charitable deduction. Fortunately, the Connecticut apportionment statute exempts such property from apportionment.)

C. Reimbursement for Federal Estate Tax on Property Included Under § 2041. Section 2207

Section 2207 grants the executor a right to recover estate tax from the recipients of power of appointment property includible in the gross estate under § 2041.

The amount recoverable is pro rata, which again means that the amount bears the same relation to the total tax paid as the property received by the beneficiary bears to the taxable estate.

To the extent a testator prefers to have general power of appointment property devolve to the appointee or appointees free of federal estate tax, the right of recovery under § 2207 may be waived by a contrary direction in the decedent's will. Section 2207 does not require an express or specific reference to the statute or reimbursement right to waive reimbursement. A general direction in the will to pay all taxes from the residue will suffice.

D. Reimbursement for Federal Estate Tax on Property Under § 2044. Section 2207A

Section 2207A grants the executor of an estate a right to recover estate tax from the recipients of qualified terminable interest property ("QTIP property") for which the § 2056(b)(7) marital deduction was allowed.

The amount recoverable is incremental. That is, § 2207A permits recovery of the amount by which taxes were increased by inclusion of § 2044 property, meaning the incremental taxes without applying any deductions or credits.

To the extent a testator prefers to have such § 2044 property pass to the beneficiary or beneficiaries free of federal estate tax, the right of recovery under § 2207A may be waived by a contrary direction in the decedent's will. Unlike §§ 2206 and 2207, however, waiver may only be made by specifically indicating an intent to waive the right to reimbursement. Therefore, a general direction in the will to pay all taxes from the residue will not suffice.

Unlike §§ 2206 and 2207, §2207A does not contain an express exception for §2044 property passing to a surviving spouse that qualifies for the marital deduction. Such proceeds are not subject to the right of recovery for the payment of estate tax, however, because the incremental tax attributable to an asset that qualifies for the unlimited marital deduction is necessarily zero. Treas. Regs. § 20.2207A-1 (a)(1). This would obviously apply to the § 2055 charitable deduction as well.

E. Reimbursement for Federal Estate Tax on Property Included Under § 2036. Section 2207B

Section 2207B grants the executor of an estate a right to recover estate tax from the recipients of property includible in the decedent's estate pursuant to § 2036.

The amount recoverable is pro rata. That is, the amount that bears the same relation to the total tax paid as the property by the beneficiary bears to the taxable estate.

To the extent a testator prefers to have such § 2036 property devolve to the beneficiary or beneficiaries

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free of federal estate tax, the right of recovery under § 2207B may be waived. Just as with § 2207A, any waiver may be made only by specifically indicating an intent to waive the right to reimbursement. Therefore a general direction in the will to pay all taxes from the residue will not suffice.

Unlike §§ 2206, 2207 and §2207A, this section does not contain an express exception for §2036 property passing to a surviving spouse that qualifies for the marital deduction. Thus, any such property would bear the burden of its fair share of estate tax. However, this section provides that no tax shall be apportioned to a qualified charitable remainder trust.

Noticeably absent from the Code are comparable statutes providing fiduciary recovery rights for nonprobate property passing under sections 2035, 2037, 2038, 2039 and 2040. The effect of this is discussed generally in Part 4 below.

F. The GSTT Apportionment Rule. Section 2603(b)

The GSTT scheme includes its own apportionment rules with respect to direct skips, taxable distributions and taxable terminations which trigger a generation skipping transfer tax. Section 2603(b) provides that with respect to (i) a direct skip, the transferor will pay the tax, (ii) a taxable distribution, the distributee will pay the tax, and (iii) a taxable termination, the trustee will pay the tax.

These default rules may be waived by the governing instrument by "specific reference to the tax imposed by this chapter." IRC § 2603(b).

2. Connecticut Law — The Default Provisions

Many commentators suggest that a comprehensive federal tax apportionment scheme is necessary to cure the morass of state and federal apportionment law. Alas, federal tax apportionment law remains quite limited. Consequently, most questions of tax apportionment are left to either state law or the governing instrument. This section considers the applicability and operation of state law. These, too, are default rules which apply only when the governing will or trust agreement does not provide otherwise.[1]

A. Proration of the Federal and Connecticut Estate Taxes: The Proration Act. § 12-401

Prior to the enactment of the Proration Act, the burden of federal and state estate taxes rested on the estate as a whole and was paid out of the residuary estate unless the will directed otherwise. *See* McLaughlin v. Green, 136 Conn. 138 (1949); New York Trust Co. v. Doubleday, 144 Conn. 134 (1956). Absent a directive to the contrary, the common law rule in Connecticut, and in most jurisdictions, was that taxes were paid out of the estate as if they were a typical administration expense. *See* Ericson v. Childs, 124 Conn. 66 (1938). This rule was criticized because it frequently caused the residuary estate, which often passes to the testator's closest relatives, to be partly or completely depleted by the payment of estate taxes on other gifts, both non-testamentary and testamentary. In 1945, Connecticut enacted the Proration Act in response to this criticism .

1. Section 12-401

Connecticut law establishes a statutory presumption that federal and state estate taxes are to be prorated among the beneficiaries. *See* Cornell v. Cornell, 165 Conn. 376, 385-86, 334 A.2d 888 (1973); Bunting v. Bunting, 60 Conn.App. 665, 675 (2000). 385-86, 334 A.2d 888 (1973); Bunting v. Bunting, 60 Conn.App. 665, 675, 760 A.2d 989 (2000).

The Proration Act provides that the amount of the federal and Connecticut estate taxes paid with respect to any property required to be included in the gross estate of a decedent shall be "equitably prorated among the persons interested in the estate to whom such property is or may be transferred or to whom any benefit accrues," except in cases where the decedent directs otherwise by will. C.G.S. § 12-401.

2. Purpose of the Proration Act

The Proration Act is intended to ensure that all the transferees of the property that constitutes a decedent's estate will pay their fair share of the federal estate tax in the absence of a clear expression of intent by the decedent that it shall not apply. 12-401 (emphasis added.)

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3. Treatment of Nonprobate Property

Not every state apportionment statute applies to nonprobate property. The Connecticut Proration Act does apply to the transfer of property which does not pass by will or intestate succession and therefore does not come into the fiduciary's possession as part of the probate estate. Such assets include life insurance, jointly-owned property, property held in inter vivos trusts, etc.

a. Generally

The Proration Act provides that the amount of estate taxes paid with respect to any property required to be included in the gross estate of a decedent shall be "equitably prorated among the *persons interested in the estate* to whom such property is or may be transferred or to whom any benefit accrues," unless the decedent directed otherwise by will. C.G.S. § 12-401 (emphasis added).

b. Definition of "persons interested in the estate"

The statute defines "persons interested in the estate" to include "all persons who may be entitled to receive or who have received any property or interest which is required to be included in the gross estate of a decedent or any benefit with respect to any such property or interest whether under a will or intestacy or by reason of any of the transfers, trusts, estates, rights, powers and relinquishment of powers, as severally enumerated in the Unites States Internal Revenue Code." C.G.S. § 12-400.

c. Gross Estate

The gross estate of a testator includes both probate and nonprobate assets. I.R.C. §§ 2031(a) and 2045. See Bunting, 60 Conn. App. at 675, (2000) (finding that because no gift tax was paid when decedent made an inter vivos gift of stock and a company building, that gift was part of decedent's gross estate for federal estate tax purposes).

d. Result

Because the gross estate includes taxes resulting from nonprobate transfers, and because "persons interested in the estate" is specifically defined to include persons who have received-property or interest in the form of nonprobate assets, it is clear that the Proration Act is applicable to both probate and nonprobate assets.

4. Waiver of the Proration Act

In addition to expressly opting out of the Proration Act (discussed below), its application can be avoided if federal and Connecticut estate tax are paid by a party or parties in interest in a manner satisfactory to such parties. C.G.S. § 12-401(b).

5. Equitable Apportionment Under the Proration Act

The Proration Act does not operate to apportion taxes to beneficiaries who receive property which did not generate any estate tax. That is, the deductible disposition alone benefits from the deduction under this scheme, known as equitable apportionment. "The estate taxes should be borne by those whose bequests contribute to the tax burden and, conversely, that all those whose legacies do not in any way create or add to [the] burden should not be required to bear it." Jerome v. Jerome, 139 Conn. 285, 292 (1952). Thus, the marital deduction should be allocated to the property passing to the surviving spouse and the charitable deduction should be allocated to the property passing to the charities.

3. Connecticut Law — Abatement Rules and Liability for Tax

Abatement v. Apportionment

The apportionment statute applies only to federal and state estate taxes, and not to debts and administrative expenses. Where the residue is insufficient to pay such debts and expenses, other statutory provisions apply. That said, apportionment and abatement do intersect.

C.G.S. 45a-365 outlines the priority of types of claims, C.G.S. § 45a-368 establishes the liability of beneficiaries, and C.G.S. § 45a-369 presents the order of liability of different beneficiaries.

A. Intersection with C.G.S.§ 12-401

The order of liability of beneficiaries that is provided in C.G.S.§ 45a-369 does not apply to the liability for an estate, succession, or other death tax with respect to property that is required to be included in the gross tax estate of a decedent. The liability of beneficiaries for such

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taxes under C.G.S. § 45a-368 is governed by the Proration Act. C.G.S. § 45a-369(d).

B. Priority of Claims Under C.G.S. § 45a-365

1. Generally

Under C.G.S. § 45a-365, taxes are entitled to preference in the settlement of a decedent's estate. In the order of priority, taxes are fourth, following funeral expenses, expenses of settling the estate, and claims due for the last sickness of the decedent.

The order of priority under C.G.S. § 45a-365 is:

1. Funeral expenses.
2. Expenses of settling the estate.
3. Claims due for the last sickness of the decedent.
4. *All lawful taxes and all claims due to the state of Connecticut and the United States.*
5. All claims due any laborer or mechanic for personal wages for labor performed by such laborer or mechanic for the decedent within three months immediately before the death of such person.
6. Other preferred claims.
7. All other claims allowed in proportion to their respective amounts.

2. Solvent Versus Insolvent Estates

The priority of claims does not change regardless of whether the probate court denominated the estate as solvent or insolvent. Computerx Pharmacy v. Appeal Probate Court of Stratford, (Conn. Super.) LEXIS 2474 at 3.

C. Liability of Beneficiaries Under C.G.S. § 45a-368

1. Generally

According to C.G.S. § 45a-368, a beneficiary is liable for taxes to the extent of the fair market value on the date of distribution of any assets the beneficiary received from the estate, when the taxes have not been recovered previously out of the fiduciary's assets. C.G.S. § 45a-368.

2. Exceptions

In order to impose liability upon a beneficiary under C.G.S. § 45a-368,there cannot be sufficient assets available for this purpose in the fiduciary's hands, in the hands of persons above the beneficiary in the order of liability outlined in C.G.S.§ 45a-369, or by the enforcement, under C.G.S.§ 45a-266, of any lien, security interest, or other charge the beneficiary holds against the assets of the decedent specifically disposed of by will or passing to a distributee, or against the proceeds of any policy of insurance in the life of the decedent payable to a named beneficiary.

3. Tax Arising From Property Included in the Gross Estate

Taxes arising from property included in the gross estate are governed by the Proration Act, C.G.S.§ 12-401, and therefore the order of liability of beneficiaries that is provided in C.G.S.§ 45a-369 does not apply. Rather liability of beneficiaries under C.G.S. § 45a-368 is governed by the Proration Act.

D. Order of Liability of Beneficiaries Under C.G.S. § 45a-369

1. Exception for Express or Implied Intent

The express or implied intention of a testator to prefer certain beneficiaries is effective to vary the order of liability prescribed in this section. C.G.S. § 45a-369 (c).

2. Statutory Order of Liability

Absent such contrary intent, beneficiaries are liable, as outlined in C.G.S. § 45a-368, in the following order:

1. Distributees.
2. Residuary beneficiaries.
3. Beneficiaries of general dispositions.
4. Beneficiaries of specific dispositions of personal property.
5. Beneficiaries of specific dispositions of real property.
6. Transfer on death beneficiaries.

3. Tax Arising From Property Included in the Gross Estate

Taxes arising from property included in the gross estate are governed by the Proration Act, C.G.S. § 12-401, and therefore the order of liability of beneficiaries that

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is provided in C.G.S. § 45a-369 does not apply.

4. Tax Clauses in Will and Trust Documents

Only after learning and understanding the various federal and state apportionment rules, and clearly ascertaining the client's intent, should the practitioner attempt drafting tax clauses for wills and trusts. Including boilerplate clauses without careful consideration should not even be considered. In fact, in many cases documents without tax clauses would do less harm than documents with boilerplate clauses included merely because they were in the form book.

Also, because the law may change or the testator may move, the careful practitioner will include comprehensive tax clauses even if the statutory default provisions comport with the testator's intent.

A. Opting Out of the Default Provisions

The Proration Act (and C.G.S. § 12-376) specifically allows the testator to direct how he or she would like taxes to be paid. In order to override the default provisions, however, it is absolutely crucial that the language in a will or inter vivos trust must be clear, definite and unambiguous such that the intent of the testator to opt out of the default provisions is manifest.

Will or Trust Agreement?

The testator has a broad power to provide by will for a different method of apportionment. And, though a settlor of an inter vivos trust may provide for a different method of apportionment, such method will apply only to the interests in property transferred by the trust. *See* Schiaroli, *Apportionment of Federal and State Estate Taxes in Connecticut*, 20 Conn BJ 198, 216.

1. Specificity

Much Proration Act litigation concerns whether a testator made a direction contrary to apportionment. *See* generally McLaughlin v. Green, 136 Conn. 138 (1949) (addressing whether direction against proration in a will applied to death taxes caused by ante mortem transfers); Jerome v. Jerome, 139 Conn. 285 (1952) (determining whether there was an effective prohibition against proration in the will); Union & New Haven Trust Co. v. Sullivan, 142 Conn. 685 (1955) (deciding whether direction against proration in will created a general power of appointment applied to the estate taxes imposed on the donee's estate on the exercise of power, thus causing taxes to be paid by the testator's estate); New York Trust v. Doubleday, 144 Conn. 134 (1956) (deciding whether there was an effective direction against proration).

The testator can direct that taxes be handled in a manner other than that prescribed in the Proration Act. C.G.S. § 12-401. Since the practical effect of testamentary direction against proration of federal and state succession taxes is to increase the size of some testamentary gifts by shifting the burden of absorbing taxes to others, the directive must be clear and unambiguous. New York Trust Co. v. Doubleday, 144 Conn. 134, 141 (1956); Crump v. Crump, 20 Conn. Supp. 471, 474 (1957).

2. Probate Versus Nonprobate Property

The Proration Act default rules require that estate taxes be apportioned against all assets, probate and nonprobate. C.G.S. § 12-401. See discussion above for a more detailed analysis.

i. Application to Probate and Nonprobate Property

In cases where the will has a directive contrary to apportionment, whether the clause applies to both probate and nonprobate assets is determined based on the wording of the clause and whether it is effective. Crump v. Crump, 20 Conn. Supp. 471, 474 (1957). With the correct wording, the clause can apply to nonprobate as well as probate assets. Id. A New York case determined that when the testator treats inter vivos transfers and testamentary transfers with equal consideration, it is indicated that the testator intends to forbid discrimination against one type of transfer or another. Matter of Andrade, 177 Misc. 532, 533, 31 N.Y.S. 2d, 25, 26 (1941).

ii. Drafting The Tax Clause

A good tax clause should expressly state (1) what gifts or beneficiaries are freed of the burden of taxes, (2) what taxes are affected, and (3) where the burden of taxes is shifted" and "[w]hile a clause may be effective even if it does not expressly cover these three elements, the use of a vague clause invites a lawsuit.[2]

The following is a list of several elements practitioners should consider including in a well-crafted tax clause:

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a. Effective override of state apportionment statutes;

b. Effective override of federal apportionment statutes;

c. Enumeration of the taxes to which the clause applies;

1. federal estate tax
2. state estate tax
3. state succession tax
4. state inheritance tax
5. generation skipping transfer tax

d. Direction as to the fund or funds from which taxes are to be paid;

e. Direction as to apportionment of nonprobate assets;

f. Direction as to apportionment of property devolving which generates no tax (equitable apportionment);

g. Whether apportionment is to be pro rata or incremental;

h. Apportionment of credits; and

i. Direction as to specific GSTT apportionment issues.

iii. Other Tax Clause Drafting Considerations

A. Conflicting Clauses in Multiple Documents

The use of pour over wills and revocable trusts is pervasive in Connecticut. In such plans, the practitioner must pay particular attention to ensure that the tax clauses in the will and the revocable trust are coordinated to effect the intent of the testator/settlor. To the extent clauses contradict one another, the will would control as to all property except that passing are held by a trust.

B. Liquidity Concerns

Notwithstanding the fact that the Internal Revenue Code provides for the right of recovery for certain includible nonprobate property, a well crafted tax clause will direct apportionment in the will and trust rather than relying on these provisions. This is because the federal statutes are not apportionment statutes, but rather rights of recovery. The executor is responsible for the payment of tax. Therefore, under the Code's recovery provisions the executor is not entitled to collect the prorata or incremental tax before it is remitted to the IRS. This can cause obvious liquidity problems where the nonprobate assets constitute a large proportion of the estate's assets. To avoid such problems the planner can simply include language in the will and trust directing apportionment for the payment of tax from these assets.

5. Common Tax Clause Traps

A. Residue Insufficient to Pay Tax

Suppose a testator effectively overrides the statutory presumption of apportionment among all beneficiaries and provides that all estate taxes shall be paid from the residue, but the residue is insufficient to pay all such taxes?

There is no statute that specifically addresses how estate taxes are to be apportioned when a will successfully directs payment of taxes but there are insufficient monies in the designated fund. Generally, though, if the residue is insufficient, specific devises, legacies and other interests will be abated in the same manner as when debts exceed the residue.

i. *Connecticut Case law*

Mosher v. United States, 390 F. Supp. 1041 (D. Conn., 1975). In Mosher there were sufficient monies to pay some but not all of the taxes out of the designated fund. The issue was whether the otherwise effective clause opting out of the apportionment statute nullified the *entire* clause with the result that all taxes should be apportioned according to the statute. The court found that the clause was still effective to the extent that there were monies in the designated fund. The court found that "[w]here, as here, a tax clause is meticulously crafted to avoid proration, it will control." Id. at 1044. Therefore, the Mosher court found that the language in the will was sufficient to overcome the statutory presumption that taxes were to be prorated under C.G.S. § 12-401. Also, the court found that because the statute was inapplicable, the charitable legacies had to ratably abate, along with the bequests to other legatees, to satisfy the payment of taxes, and therefore the estate was not entitled to a refund.

ii. New York Case law

Connecticut's Proration Act is based on New York's, and therefore New York cases are particularly instructive. In New York, "[I]t is a well-established principle that when the fund indicated in the will as the source of all tax payments, is either nonexistent or insufficient to pay estate taxes in full..." the New York apportionment statute "then becomes operative. Under that rule all persons benefited contribute to the tax in proportion to their respective benefits." In re Estate of Kramer, 78 Misc. 2d 662, 665, 356 N.Y.S.2d 984, 989 (1974).

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A. Matter of Collia, 123 Misc.2d 1014, 475 N.Y.S.2d 237 (1984).

In Collia, the decedent's intent was to have taxes arising from all testamentary and non-testamentary assets paid from the residuary. The residuary monies, however, were insufficient. The court stated that "where the fund indicated in the will of a decedent as the source of all tax payments is either nonexistent or insufficient to pay estate taxes in full, the statutory rule of apportionment becomes operative, and the tax is required to be equitably allocated against all persons interested in the estate in proportion to their respective benefits." Id. at 1018.

B. Matter of Andrade, 177 Misc. 532, 31 N.Y.S.2d 25 (1941).

Andrade held that when the testator contemplated that a specific fund would be sufficient to pay all estate taxes and expenses, and treated inter vivos transfers and testamentary transfers with equal consideration for that purpose, it indicated that the testator forbid discrimination against one type of transfer or another. Id. at 533. The court also stated that the opposite result would be unjust, as one person's benefit would be improperly and unlawfully reduced, while the other's would be freed from contribution altogether. Id. at 534.

B. Increase in Aggregate Tax Liability

Overriding the default apportionment statute without carefully considering the consequences can increase the aggregate tax by apportioning tax to assets qualifying for the marital or charitable deductions.

Suppose a testator leaves her residuary estate equally to her children and a qualified charity. Suppose further that her will contained a standard burden-on-residue tax clause, which purported to charge all estate taxes to the residue and to waive all rights of reimbursement for estate taxes. What result?

Under similar facts in the Estate of Bradford, TCM 2002-238, the IRS assessed additional tax asserting that taxes must be subtracted prior to the split, reducing the amount of the gift passing to the charity and thereby increasing the tax liability by several hundred thousand dollars.

C. Unintended Distribution/Disinheritance

Overriding the default apportionment statute without carefully considering the consequences can cause unintended distributions and even unintended disinheritance of a beneficiary.

Suppose a testator desires to benefit his two children equally. His assets consist of a business interest worth $1,000,000 and other assets worth $1,000,000. Child A is an employee of the business. In order to ensure A's control of the business, father makes a specific bequest of the business interest and left the residue to A and Child B equally, after off-setting A's specific bequest. Suppose further that father's will contains a boilerplate payment of tax out of the residue tax clause, without apportionment. Because the estate tax will be paid wholly by the residue, A will receive a greater proportion of father's estate and pay less tax than B – to the frustration of father's intent.

Planners must carefully consider the client's desire with respect to the payment of transfer taxes and thoughtfully prepare the tax clause. A good estate plan will contemplate and harmonize the applicable tax clauses in all estate planning documents (wills, revocable trusts, irrevocable trusts), consider the nature of property passing and to whom, and reconcile federal and state default statutes with the will and trusts.

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[1] Typical language provides: *I direct my Executor to pay from my residuary estate, as administration expenses, without apportionment, all estate, inheritance, succession, and death taxes (including interest and penalties thereon) with respect to any property required to be included in my gross estate for purposes of such taxes, whether such property passes under this will or otherwise.*

[2] Note, 37 A.L.R.2d 7, 13-14 § 1; see Cornell v. Cornell, 165 Conn. 376 (1973)

SOME PRACTICE SUGGESTIONS FOR THE LESS EXPERIENCED ESTATE PLANNER

BY THOMAS M. FLANAGAN

Virtually all aspects of estate planning and estate and trust administration have changed dramatically in the last 30 years. In addition to the constant changes to state and federal transfer tax laws, and changes to estate, probate and trust law, we have witnessed a tremendous increase in the use of trusts of all types and in particular the use of revocable or living trusts as will substitutes.

We now also provide our clients with a variety of ancillary documents for our clients to consider, most of which did not exist 30 years ago. These include at the very least living wills, appointments of health care representatives and durable powers of attorney.

Perhaps most importantly for the purposes of this article, developments in the area of professional responsibility, concerns with what we might call "best practices", and the practical aspects of an estate planning practice have introduced a variety of requirements and procedures to the modern practice, many of which did not exist 30 years ago. These topics are the focus of this article.

If we compare the process of addressing a fairly standard planning engagement for a married couple with some exposure to state and federal death tax concerns 30 years ago with the same process for similar clients today, we can highlight many of the issues and procedures which you should keep in mind as your practice develops. These concepts are not particularly complicated, but even experienced practitioners sometimes overlook some important procedures.

The Planning Process in 1980

Let's assume that the hypothetical new clients of 30 years ago were a husband and wife who were happily married and who needed at least a marital/non-marital trust arrangement which would take advantage of the unified credit or federal estate tax exemption of the first to die by establishing a non-marital trust under the pre-1981 federal estate tax rules. The non-marital trust may have been a so-called "spray trust" allowing the trustee to make distributions to a class consisting of the surviving spouse and issue. Let's also assume that the plan included an irrevocable insurance trust with so-called Crummey withdrawal powers.

In 1980 the estate planning attorney may have sent the new clients an engagement letter outlining the fee arrangements and the scope of the engagement, although that would have been rare at the time and was not required under the Rules of Professional Responsibility. It is highly unlikely that the estate planning attorney would have discussed possible conflicts of interest which might arise when one attorney represents both parties. A joint representation letter or memorandum addressing these issues would have been almost unheard of at the time.

The plan may or may not have included revocable trusts. Perhaps the non-marital trust was established under the wills. It would not have been unusual at the time for the clients to name a Trust Company as executor and/or trustee, or even to name the estate planning attorney in a fiduciary capacity.

The clients may or may not have been asked to fill out a detailed estate planning questionnaire which would indicate important financial and personal information (including the citizenship of each client). 401(k) plans, IRAs and potentially complicated beneficiary designation choices probably would not have been significant issues at the time.

The letter transmitting the draft documents for review by the clients may or may not have been detailed, perhaps including diagrams illustrating the operation of the documents.

The operation of the irrevocable trust during the lifetime of the insured may have been explained in detail, although it is possible that a Bank Trust Department may have offered to help administer the trust as a loss leader. If the trustee of the irrevocable trust was someone other than a Trust Company or an attorney, the estate planning attorney may or may not have provided written guidance regarding the administration of the trust during the lifetime of the insured.

When the documents were executed the attorney no doubt would have sent at least conformed copies to the clients, although it is not likely that a closing letter (or end of representation letter) would have been sent to the client, or even considered. The estate planning attorney may have volunteered to keep the original documents at the firm, which would not have been unusual.

The clients may have been advised to re-title assets owned jointly with the right of survivorship in order to ensure that the plan would work regardless of the order of death, or to try to allocate future accumulation of assets in the name of

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the spouse with the smaller estate.

The attorney may have maintained some type of database containing relevant information regarding the operative provisions of the documents (for example, date signed, type of marital deduction formula, trustee information, etc.).

Some Typical Post-Execution Developments

If the hypothetical clients from 1980 are still alive today, it is likely that they have received a barrage of communications from the estate planning attorney over the last 30 years (if he or she is still alive) addressing the constant changes in federal estate, gift and generation-skipping tax law, as well as changes in state tax, trust and estate administration law.

The clients might have executed updated plans several times during that period. Each such engagement would have offered the planner the opportunity to update the file information and to learn whether any prior suggestions such as allocating assets between husband and wife were followed. Often they were not. In other cases the original advice was followed at first but later forgotten.

Here are a few examples of later developments which might have compromised the clients' estate plan:

1. The clients might have changed investment advisors or opened a new account with all or much of their assets owned jointly with the right of survivorship even though you had recommended a different approach.

2. The clients might have purchased a new residence in survivorship even though title to their prior residence had been in one name only.

3. The clients might have purchased life insurance or an annuity without discussing ownership or beneficiary designation issues.

4. The attorney might have prepared a beneficiary designation for a retirement account with a disclaimer option, but the client might later have moved the account to another advisor without having updated the beneficiary designation.

5. If part of the client's estate included stock in a closely-held C Corporation, the client's accountant might later have recommended that the Corporation convert to Subchapter S status without the attorney's knowledge. In that case the non-marital spray trust would no longer be eligible to hold the stock after the client's death without jeopardizing the Subchapter S status of the Corporation.

6. If the trustee of the irrevocable trust was not an expert or familiar with the operation of the trust, the formalities of the trust, including especially the withdrawal notices, might have been ignored or forgotten.

2010 Procedures

With this background in mind here are some things you should consider if you meet new clients, with the same planning concerns, in 2010.

1. Engagement Letter. You are now required by the Rules of Professional Responsibility, and it is good practice in any event, to provide the clients with a written engagement letter which sets forth your fee arrangements and billing methods. The letter should outline the scope of the engagement, including what is covered and what is not covered, and how you would address matters which are outside the scope of the engagement. Ideally the client should sign the letter.

2. Joint Representation Issues. You should provide the clients with a joint representation letter or memorandum which at least raises the issues which might arise when an attorney represents both parties in an engagement. The clients should sign the letter or memorandum. Conflict of interest issues can obviously arise in a variety of estate planning circumstances, and in many cases will be apparent to the clients. That is not always the case with happily married couples. Unfortunately things sometimes change. It should also be noted that these issues are often overlooked when the engagement involves children who are seeking to help a parent with planning issues, which can be particularly difficult depending on the circumstances. In these situations it is critical that you identify the client and that you make that clear in the conflict of interest letter or memorandum. Usually it will be the parent.

3. Estate Planning Questionnaire. You should develop a good questionnaire and ask the clients to complete the questionnaire to ensure that you are in possession of all relevant information, including, for example, assets, ownership, citizenship, etc. Your form should indicate that you are relying on the information in making your recommendations to the clients, and you may want to ask the clients to sign the form.

4. Memoranda to the File and Correspondence with the Clients. It is good practice to have detailed notes of your discussion with clients, which can help if questions

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arise later, or when you are reviewing the files years later. If you identify issues which may be the source of difficulties later, such as decisions regarding particular beneficiaries, it is also a good idea to mention those issues in your correspondence to the clients. This avoids any misunderstanding and also provides a record for the future.

5. Familiarity With the Connecticut Probate System, Funded Revocable Trusts and Related Issues. Even for clients who had revocable trusts 30 years ago, it was fairly rare for the trusts to be funded during lifetime except in cases of advanced age or incapacity. That has obviously changed over the years and you should be able to explain to the clients your views on whether everyone needs a revocable trust, whether the trust must be funded during lifetime in all cases and the issues which can arise under our current system when a trust is funded and the Grantor dies. Compared to many states Connecticut has a probate system which is not difficult to navigate when administering an estate. You should remember that the probate process is designed to protect the wishes of the testator as expressed in the will, as well as the interests of the beneficiaries and creditors. At the same time Connecticut trust law is not as extensive as estate law, although that is changing, and will likely change further if we adopt some version of the Uniform Trust Code. These comments are not intended to advocate any particular view with respect to the question of whether a revocable trust should always be funded during the grantor's lifetime. Nevertheless, more and more clients are hearing about the issue and practitioners should be able to present an informed view for their benefit.

6. What if You are Asked to Serve as Executor or Trustee? While this practice was not unusual in the past you should exercise extreme caution if you are asked to serve in a fiduciary capacity, particularly if the clients are new. Many firms have a policy which absolutely prohibits service as a fiduciary. At the least you are required to explain the implications to the clients, to discuss other choices with them and to provide them with a written disclosure of the issues which can arise when a drafting attorney is named as an executor or trustee.

7. How Do You Explain the Plan to the Clients? The question of how you provide the clients with a meaningful explanation of all of the documents which are included in even a fairly typical plan is more difficult than it might appear. Most experienced estate planning attorneys have developed a method for explaining the growing mass of documents which will be sent to the clients for their review after the estate planning conference, and which will often seem overwhelming to the clients when they arrive. If you are not practicing at a firm which has forms in place, or if you do not subscribe to an organization which provides forms for this purpose, you should develop some form of letter or outline, perhaps accompanied by diagrams illustrating the operative provisions of the wills and trusts, so that the clients will find it easier to understand the documents. This will also enable the clients to understand the operation of the documents later, when they have forgotten much of what they learned during the estate planning conference. If you do not already have forms for this purpose, it is harder than you think to find the right balance between providing too much or too little information. Your letter or outline should also address the ancillary documents, including in particular the durable power of attorney, which is an extremely powerful instrument, particularly if it includes gift-giving authority. New York recently updated its durable power of attorney statute and statutory forms and a speaker at a recent conference in New York indicated that he planned to set aside one to two hours of the client meeting just to discuss the durable powers of attorney.

8. Storage of Original Documents. It would have been fairly typical 30 years ago for original documents to be stored with the estate planning attorney or perhaps in a safe deposit box at the Trust Company if the Bank was serving in a fiduciary capacity. Many firms do not wish to keep the original documents and you should familiarize yourselves with each side of this issue.

9. Transmission of the Executed Documents or Copies and Related Future Issues. The process by which you send the original versions of the executed estate planning documents (or, depending on the circumstances, conformed copies of the documents) should include information which addresses any issues which require further attention, your understanding of who is responsible for addressing those issues and some guidance to the clients regarding recommendations for the future which will help keep the plan on track. Developing a generic memorandum addressing circumstances which may require review of the estate plan and giving it to the client is also a good idea. Many attorneys send a binder with copies of the documents and the materials which explain the operation of the documents as part of this

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process. If the plan includes an irrevocable trust it is a good idea to provide some written guidance to help ensure that the trustee does not overlook important trust administration issues. That might include a memorandum on the operation of the trust and sample Crummey withdrawal forms.

10. Instruction for Family Members and Fiduciaries. Even a detailed estate planning questionnaire may not cover all issues which arise when a client dies. Clients often have particular wishes regarding funeral and burial instructions, people to be contacted in the event of death, obituaries, etc. Information regarding their personal records, location of important papers and names and addresses of advisors is not always included in an estate planning questionnaire. Many attorneys provide the clients with a form which contemplates such information, which can help simplify the process after death.

11. Closing Letter. You should familiar yourself with the nature of your relationship with the clients after the completion of the estate planning engagement, which may lead you to conclude that you should inform the clients, during your discussions and also in writing, that you will have no further responsibilities regarding the matter unless the clients request additional services. This is a complicated topic for many reasons, and can seem counterintuitive to the estate planning lawyer, who often maintains a relationship with the clients for many years (or hopes that this would be the case). The chaos surrounding the state of the 2010 federal estate tax law means that many documents executed prior to 2010 will require review and modification. This fact will no doubt give rise to situations in which the continuing nature of the attorney-client relationship will be examined, even in cases where the estate planning attorney has sent an end of representation letter to the clients. Some experts wonder whether we have a duty to advise clients of changes in the law in all events.

12. Database. If you are in the early stages of an estate planning practice you should explore options for establishing a database to help you keep track of important information relating to executed estate plans and future responsibilities. This will make it easier to contact clients each time a change in the law raises the possibility that the clients' plan should be reviewed, or each time you have changed some aspect of your approach to drafting documents. The database can also include information relating to the allocation of responsibilities for future tasks such as the preparation of gift tax returns or fiduciary income tax returns.

No set of procedures is perfect or all encompassing, particularly in an area of practice where changes in the law are constant and changes in the clients' lives are to be expected. Hopefully these fairly basic concepts will add to your developing practice (or help you modify your existing practice to take into account the altered estate planning landscape), help the clients keep their plan on track and provide guidance for the clients and their family members after the plan has been executed.

THE EFFECTIVENESS OF RETENTION CLAUSES AND EXCULPATORY LANGUAGE UNDER CONNECTICUT LAW

BY CHARLES E. COATES III
AND CHARLES W. PIETERSE
WHITMAN BREED ABBOTT & MORGAN

In Connecticut, many a precedent can be cited for the proposition that the testator's intent controls the construction and application of testamentary language. In a judicial metaphor suggestive of the days when ships from New London and New Haven circled the globe, Justice Haines observed in *Bridgeport City Trust Co. v. Shaw*, 115 Conn. 269, 272 (1932) that the testator's intent is the "polestar" of testamentary interpretation. [1]

More specifically, the Connecticut courts have long recognized that a settlor may both broaden the investment powers of a trustee (e.g., authorize retention of assets that might not ordinarily be considered "prudent") and modify the standard by which his conduct will be measured (e.g., provide for exculpation from liability). For example, in *U.S. Trust Co. v. Bohart*, 197 Conn. 34, 48-49 (1985), the settlor's inclusion of general retention language was held to permit the trustee to make speculative or hazardous investments that would otherwise be inappropriate for a prudent investor. This included the retention by the trustee of a concentrated investment in stock of a company founded by settlor. [2]

The concepts of retention and exculpation also are incorporated into the Connecticut statutes governing fiduciary conduct. Conn. Gen. Stat. §45a-204 expressly permits trustees to retain securities that are delivered to them upon creation of the trust without liability for losses resulting from depreciation of such securities. Conn. Gen. Stat. §45a-234(1) permits a testator or settlor, simply by reference to the Connecticut Fiduciary Powers Act, to grant the fiduciary power to retain property of any kind, notwithstanding the fact that in the absence of this grant retention would be inappropriate. Finally, Conn. Gen. Stat. §45a-234(38) permits testators and settlors to grant exculpation to fiduciaries by a simple reference to the statute. [Conn. Gen. Stat. §45a-234(38) does not limit the permitted scope of exculpatory language, but provides a statutory alternative to a specifically drafted exculpation clause.]

These longstanding precedents and statutory provisions were not superseded by Connecticut's adoption of the Prudent Investor Act ("PIA") in 1997. The PIA changed and codified the standards by which trustees are governed when managing investments, but the Act makes clear that its terms may be eliminated or altered by the express terms of a trust. *See* Conn. Gen. Stat. §45a-541a(b).

Not all citizens of the Nutmeg State with special knowledge of the subject look with favor on these aspects of Connecticut law. John H. Langbein, Sterling Professor of Law and Legal History at Yale Law School, has been an advocate for the position that some fiduciary responsibilities should not be waiveable. *See* John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105, 1111 n. 65 (2004). This view also is reflected in some provisions of the Uniform Trust Code ("UTC"), which seek to increase the consideration given to the desires and interests of living beneficiaries as contrasted to the "dead hand" of the testator or settlor. Section 105(b) of the UTC lists certain trust requirements that may not be waived. A repeating theme is the requirement that the trust be operated "in accordance with...the interests of the beneficiaries" and "for the benefit of the beneficiaries." Section 802, in speaking of the fiduciary's Duty of Loyalty, declares that "a trustee shall operate the trust solely in the interests of the beneficiaries." The UTC does not render irrelevant the expressed intentions of the testator or settlor, but there is an indisputable shift in the weight given to such intentions from "polestar" to "one of several considerations."

The UTC has not, of course, been adopted in Connecticut, although its provisions allowing the removal of trustees at the request of all beneficiaries have been added to Connecticut General Statutes Section 45a-242. As a result, the extensive Connecticut case law upholding and enforcing the terms of retention clauses and exculpatory language continues to control.

In crafting a retention clause, narrowly-framed language is more readily enforced than a generally-worded clause. *See* Jeffrey A. Cooper, *Speak Clearly and Listen Well: Negating the Duty to Diversify Trust Investments*, 33 OHIO N.U. L. REV. 903, 922-28 (2007). Indeed, one commentator (who has admitted a negative opinion of corporate trustees) nonetheless declares that courts tend to enforce exculpatory provisions and shield trustees from liability where the clause "relates directly

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to the settlor's direction that the trustee retain specific, relatively risky investments, and the beneficiaries seek to hold the trustee liable for the handling of those investments...". Melanie B. Leslie, *Trusting Trustees, Fiduciary Duties and the Limits of Default Rules*, 94 Geo. L.J. 67 (Nov. 2005).

Moreover, the right of a testator or settlor to limit the fiduciary's liability is not itself unlimited. The settlor of a trust cannot (i) grant to his trustee discretion that is so broad or unlimited that it insulates his actions from judicial review, *Connor v. Hart*, 157 Conn. 265, 274 (1968), or (ii) exculpate his trustee for conduct which constitutes bad faith or willful misconduct. *See* 4 MARK L. ASCHER ET AL., SCOTT AND ASCHER ON TRUSTS § 24.27, at 1798-99 (5th ed. 2007). In Connecticut, willful misconduct on the part of a trustee requires a showing that the trustee (i) intended to harm a beneficiary or (ii) recklessly disregarded the rights of the beneficiary. *See Narumanchi v. Mechanics Savings Bank*, CV 000434264, 2000 Conn. Super. LEXIS 2502, at *15-16 (Sept. 20, 2000) (gross negligence, although not defined in Connecticut has been equated with "willful misconduct" or something "more than ordinary negligence but less than reckless or willful misconduct"). [3]

Several recent cases from other jurisdictions also have enforced retention/exculpation clauses and shielded trustees rom liability for losses resulting from concentrated holdings. *See Nelson v. First Nat. Bank*, 543 F.3d 432 (8th Cir. 2008) (enforcing general retention/exculpation clause); *Americans for the Arts v. Lilly*, 855 N.E.2d 592 (Ind. Ct. App. 2006) (enforcing general retention clause); *In re Wege Trust v. Fifth Third Bank*, No.271244, 2008 Mich. App. LEXIS 1259 (June 17, 2008) (enforcing general retention language). It is noteworthy that the courts in *Nelson, Americans. for the Arts* and *In re Wege Trust* protected the trustee despite the fact that the relevant trusts lacked highly specific retention language, and instead involved a general, non-specific retention clause.

Perhaps the most ironic case in the last few years on the issue of retention vs. diversification was *In re Scheidmantel*, 868 A.2d 464 (Pa. Super Ct. 2005). The trust included an exculpation clause that relieved the Trustee from liability except for fraud, gross negligence or willful misconduct. As a result of a series of bank mergers or acquisitions, eventually over 86% of the trust principal came to be invested in stock of the bank that served as Trustee. Clearly concerned over its potential liability as a result of this concentrated position, the Trustee actively diversified, but failed to consult the beneficiaries or to document the basis for its change of investment philosophy. When it developed that the newly-diversified investments substantially underperformed the concentrated holding of bank stock, the beneficiaries objected to the Trustee's account. Although the court acknowledged the virtues of diversification, it found on the facts that the bank had acted with "gross negligence" in eliminating the concentrated investment in its own stock. Thus the exculpatory language of the instrument was used by the court not as a shield to protect a fiduciary who retained a concentrated position, but as a sword to assault a fiduciary who elected to diversify a concentrated position.

Connecticut case law and statutes still extend to the fiduciary the protection afforded by carefully-drafted retention clauses and exculpatory provisions, although exceptional cases always will arise based on bizarre facts. The best insurance against such exceptions is provided by regular, documented communication between fiduciary and beneficiaries.

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[1] *See also Connor v. Hart*, 157 Conn. 265, 275 (1968) ("expressed intent of testator must control"); *Gimbel v. Bernard F. & Alva B. Gimbel Found, Inc.*, 166 Conn. 21, 26 (1974) (well settled that "intent of testator must control"); *Conn. Bank & Trust Co. v. Hartford Hosp.*, 29 Conn. Supp. 158, 164 (1971) ("effect is given to the intent which finds expression in the language used").

[2] *See also Jackson v. Conland*, 178 Conn. 52, 56 (1979) (enforcing settlor's direction that trustee not be held to standard of prudent investor and limiting trustee's liability to acts constituting willful misconduct); *Kimball v. New England Trust Co.*, 14 Conn. Supp. 432, 440-47 (1997) (enforcing exculpatory clause excusing trustee from investment losses not due to bad faith or willful default); *Trust under the Will of Moran*, 17 Quinn. Prob. Law Jour. 50, 53-55 (P.Ct. Darien, CT 2002) (where beneficiary sought surcharge, not for actual loss, but "absence of greater gain" in trust portfolio, trust's language precluding liability for investment losses except in case of "willful misconduct" supplanted prudent investor standard); *Beckenstein v. Reid and Reige, P.C.*, 967 A.2d 513, 521-23 (Conn. App. Ct. 2009) (construing scope of exculpation clause and terms 'gross negligence' and 'willful misconduct').

[3] *See also Ramondetta v. Amenta*, CV030825102, 2004 Conn. Super. LEXIS 3408, at *10 (Nov. 15, 2004) (bad faith implies a dishonest purpose or a design to mislead or deceive, or a neglect or refusal to fulfill some duty prompted by a sinister motive); *Kimball v. New England Trust Co.*, 14 Conn. Supp. 432, 440-41 (1947) ("To excuse a trustee except for a willful default means to excuse him from the consequences of any breach of trust that he did not intend to co-

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mmit knowing it to be a breach of trust and from responsibility for any loss that he did not intend to bring about"); *Jackson v. Conland*, 178 Conn. At 53, 57 (defining willful misconduct as conduct not negligence, not a failure to exercise good judgment, but rather an intentional act to do a wrong to a beneficiary or conduct in reckless disregard to the rights of a beneficiary); *Barlow Bros. Co. v. Gager*, 113 Conn. 429 (1931) (defining "willful misconduct" as not negligence or failure to exercise good judgment, but intentional wrongdoing or misconduct in reckless disregard of the beneficiaries' interests).

INSOLVENT ESTATE ADMINISTRATION: WHY §45A-365 IS SCARILY MISLEADING

DOUGLAS R. BROWN, Esq.

BRODY WILKINSON PC

Insolvent estate administration in Connecticut can be very challenging for a lawyer who is unaware that Connecticut General Statutes §45a-365, a straightforward statute on the order of priorities between claims, expenses, and taxes in insolvent estate administration, often does not control the order of priorities. There are some key exceptions not referenced in the statute that alter the order of priorities in insolvent estate administration. This article shall highlight the most important exception.

An estate is insolvent if there are not enough estate assets to pay off fully the outstanding claims of the estate. In such estates, Connecticut General Statutes §45a-365 seemingly governs the order of priorities in Connecticut concerning the payment of claims, expenses, and taxes. It is refreshingly easy to read, stating:

§ 45a-365. Order of payment of claims, expenses and taxes

Claims, expenses and taxes in the settlement of a decedent's estate shall be entitled to preference and payment in the following order of priority:

(1) funeral expenses;

(2) expenses of settling the estate;

(3) claims due for the last sickness of the decedent;

(4) all lawful taxes and all claims due the state of Connecticut and the United States;

(5) all claims due any laborer or mechanic for personal wages for labor performed by such laborer or mechanic for the decedent within three months immediately before the decease of such person;

(6) other preferred claims; and

(7) all other claims allowed in proportion to their respective amounts.

Unfortunately, this statute often does not govern.

In every estate where the lawyer is presented with the possibility of insolvency, the lawyer must consider first whether the decedent died with federal tax problems. This exercise is almost never academic, because if the decedent died with unpaid mortgage payments, unpaid credit card bills, or unpaid service providers, there is a very good chance that the decedent was not diligent in paying taxes to the IRS. And if the decedent did not file his or her recent tax returns, the IRS is likely unaware of the delinquency and has not filed a claim.

The IRS claim is also extremely dangerous for the fiduciary settling the estate because it has a much higher priority than that stated in §45a-365. The IRS claim is not relegated to the #4 position clearly stated in §45a-365; instead, it falls in between the #2 position and the #3 position in priority subordinate only to the funeral expenses and the administration expenses of settling the estate.[1]

The federal government takes the position that the claims of the United States are not bound by §45a-365. See United States v. Craft, 535 U.S. 274, 288 (2002). Under section 3713(a)(1)(B) of Title 31 of the United States Code:

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"A claim of the United States Government shall be paid first when ... the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor."

The U.S. Supreme Court has interpreted the federal statute to apply to "all the insolvent's debts to the Government, whether or not arising from taxes, and whether or not secured by a lien." United States v. Vermont, 377 U.S. 351, 357 (1964). In addition, the estate fiduciary must be particularly mindful of the federal priority because the federal insolvency statute provides that "a representative of ... an estate ... paying any part of a debt of the ... estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government." 31 U.S.C. §3713(b). As such, the estate fiduciary is looking at possible personal liability for paying a claim which is ultimately subordinate to a claim of the IRS.

Although all other claims of the insolvent estate are subordinate to the claims of the IRS, funeral expenses and administration expenses of settling the estate still maintain priority under federal law. In Kennebec Box Co. v. O.S. Richards Corp., 5 F.2d 951 (1925), the order of priority was contested between the receiver of a corporation for receivership expenses and the United States for taxes. In ruling in favor of the receiver fiduciary, the Second Circuit declared that "there is and can be no claim in favor of even the most preferred of creditors until there is some fund available for the payment of all creditors...." Id. at 952. By analogy then, an estate fiduciary's administration expenses, including reasonable legal fees and reasonable fiduciary fees, have priority over claims of the IRS in insolvent estate administration. [2]

When a person dies, the surviving family members will usually raise at the first estate settlement meeting that the decedent died in financial difficulty. If the lawyer has any knowledge that there may be an issue regarding insolvency, the lawyer must approach the estate settlement differently than he might for a solvent estate. Before the lawyer authorizes the payment of any claims, expenses, or taxes, the lawyer must become familiar with all assets and all debts of the decedent. The lawyer must become familiar with whether the decedent's assets are categorized as probate assets or as nonprobate assets. The lawyer should explain to the client that there is likely to be some period of nonpayment of bills until those bills are presented to the probate court for either payment or nonpayment.

A lawyer representing a fiduciary of an insolvent estate must be cognizant of the Connecticut order of priorities under §45a-365, but that lawyer must also be aware of how federal law conflicts and impacts upon each insolvent estate. In every insolvent estate, the lawyer for the fiduciary must consider the decedent's possible IRS debt before authorizing the payment of any claim in the estate settlement.

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[1]Whether a secured creditor has superior priority is outside the scope of this article.

[2]The author has successfully used Kennebec as legal support for priority of administration expenses over IRS claims in several insolvent estate administrations.

CONNECTICUT BAR ASSOCIATION

30 Bank Street
P.O. Box 350
New Britain, CT 06050-0350

Phone: 860-223-4400
Fax: 860-223-4488
E-mail: msc@ctbar.org

WE'RE ON THE WEB

WWW.CTBAR.ORG

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