

DAVIDSON, DAWSON & CLARK LLP
C O U N S E L L O R S A T L A W

CLIENT MEMORANDUM

ADMINISTRATION OF TRUSTS
IN NEW YORK

INTRODUCTION

It is sometimes desirable and cost-effective to have individuals who are not professional fiduciaries serve as the trustees of family trusts. The following is a very general guide to the rights and responsibilities of trustees under New York law. More specific advice relating to a particular trust may also be helpful and necessary; we are glad to advise you in such matters.

Trust administration can be complicated. The rules have been developing for centuries. They vary from state to state and are strongly affected by the terms of the particular trust. In addition, the common law principles of trust accounting differ from the IRS rules for tax accounting, so two sets of records must be maintained. These and other unavoidable complexities make it necessary for the nonprofessional trustee to consult with a professional from time to time. Nevertheless, there is much that an individual can do alone.

WHAT IS A TRUST?

A trust is simply identified property held by one or more persons (the trustees), for the benefit of another person or persons (the beneficiaries) under a

recognized framework of rules. Trusts may be established either under a Will, or by means of an agreement signed by the donor (or "Grantor" or "Settlor") and one or more trustees. While trusts are usually evidenced by a written document, many of the rules governing trusts are found in the law and are not recited in the document itself.

Trusts are sometimes established in order to manage assets, sometimes to achieve tax benefits, and sometimes to care for beneficiaries. The three objectives often overlap.

THE TRUSTEE

With very limited exceptions, only an individual or an authorized bank or trust company can serve as a trustee. Trusteeships are normally voluntary. In the case of a Will, the trustee assumes responsibility by filing an "acceptance" in court after the testator's death. In the case of a trust established by an agreement, the trustee assumes responsibility by signing the agreement, or by agreeing to act as a successor trustee at a later date. Both types of instruments usually forgive bond, but if not, a commercial bond (from an insurance company) may be required to guarantee the trustee's proper performance.

A trust may have any number of trustees, although administration becomes more unwieldy as the number grows. Two or even three trustees are not uncommon. The general rule is that trustees must act unanimously unless the trust instrument provides otherwise. In the event of a serious difference of opinion among trustees, a Court resolution may be necessary.

SOME TRUSTEE RESPONSIBILITIES

The trustee is responsible for collecting the assets of the trust and keeping them safely within his control. The trustee must clearly identify the trust assets as being the property of the particular trust and not of the trustee, and invest them in the manner required by law or the trust instrument. The trustee is also responsible for carrying out any specific directions found in the trust instrument (i.e. the Will or the Trust Agreement) relating, for example, to disbursing funds to the beneficiaries. The trustee is responsible for keeping complete records and attending to tax and in some cases Surrogate's Court filings.

A. Collection and Safekeeping of Assets

Upon qualifying, the trustee becomes responsible for seeking out, identifying, and taking control of the assets given to the trust by the grantor or decedent. The Will or Agreement specifies those assets transferred to the trust, or their value. In addition, a trust may be the beneficiary of an insurance policy or employee benefit plan.

A trustee who succeeds another trustee is generally responsible for being sure his predecessor delivered all the trust assets to him.

When assets are received, the trustee should be sure they are safe from harm, loss or theft, and are identified as belonging to the trust. For example, in the case of cash or securities, the trustee should establish a separate bank, brokerage or custody account in the name of the trust. The trust can be identified for this (and all other) purposes in any number of ways, but the following examples are sufficient:

"Jane Doe and her successors as trustees under Article FIFTH of the Will of John Doe"

"Jane Doe and her successors under Agreement dated January 1, 1990, with John Doe, grantor"

For large trusts, the use of a custody account may be advisable because the assets are not at risk if the bank becomes insolvent. Assets in a brokerage account are owned by, and subject to claims against, the brokerage firm.

The trustee should also ask an accountant or attorney to obtain a tax identification number for the trust. This is the equivalent of a Social Security Number.

B. Investment of Assets

New York has a modern "Prudent Investor Act" which allows trustees broad flexibility in investing. They are required to exercise reasonable care, skill, and caution, and to consider the purposes, terms and provisions of the trust. Within this framework, however, they may consider such factors as taxes, inflation, economic conditions, and other trusts, income and resources of the beneficiaries, in choosing investments. The trustee must, however, diversify investments unless the trustee reasonably determines that the interests of the beneficiaries dictate otherwise. The selection of the portfolio as a whole must be reasonable and prudent; individual assets may be risky if they are balanced by other investments.

The trustee must review trust investments immediately upon receipt and continually thereafter. He may delegate investment management to a carefully selected professional, so long as he periodically reviews the professional's actions. The trustee's efforts are judged by his methods, not his results, so proper procedures are important.

C. Compliance with the Terms of the Trust.

The trustee should review the trust instrument with a professional to familiarize himself with his rights as soon as the trust is established.

Typically a trust will, at a minimum, require or allow income to be paid to a beneficiary for a specific period of time. In such case the trustee must calculate the income, deduct income-related expenses, and distribute the net amount regularly as the trust requires. The trustee may also be able to spend the income for the beneficiaries rather than disbursing it directly to them. For example, the trust may permit the trustee to pay educational expenses directly.

D. Know the Beneficiaries

In order to select the best types of investments for the beneficiaries and exercise any discretionary power over distributions wisely, the trustee should also know the circumstances and needs of the beneficiaries.

A trust may have one or more beneficiaries. Typically some will be entitled to income and/or distributions of principal for specified purposes. Others (called "remaindermen") may be entitled to receive the balance left over in the trust after a specified event, such as the death of the income beneficiary. The trustee must be fair to all these beneficiaries.

E. Care; Skill; Attention

A trustee is responsible for administering a trust carefully and skillfully. For example, large cash balances should not go uninvested. A family trustee is not held to the same standard of skill as a professional, but by accepting the trust he effectively represents himself as having sufficient business experience to manage the trust.

The trustee is also responsible for administering the trust personally. He is generally not allowed to delegate decision-making responsibility to others. He can, however, hire accountants, attorneys, investment advisors, and other professionals as long as he chooses them carefully, supervises them, and makes the final decisions himself.

F. Avoidance of Self Dealing

A trustee should be extremely careful not to involve the trust in any way with his own affairs. For example, having the trust invest in the trustee's own business, or having it make loans to or receive loans from the trustee as an individual or his family, would be grounds for removal of the trustee and assessment of any losses incurred by the trust in the transaction against the trustee personally.

G. Record Keeping

Under general trust law, all beneficiaries of the trust (including remaindermen) are entitled to assurances that the trust funds have been properly managed. Unless they sign waivers from time to time, they are entitled to a complete review of all trust transactions for the entire lifetime of the trust. The trustee will therefore make complete and orderly record keeping a high priority. Trust records should

never be discarded until after a trust is terminated (and probably not for several years thereafter). Good records are also needed to ensure that accounting difficulties and tax problems do not make the administration of the trust unnecessarily expensive.

INCOME TAXES

Most trusts are separate entities for income tax purposes. They file a separate tax return (on Form 1041) every year, on April 15th. They must also pay estimated taxes.

Trust income is not, however, subject to two layers of tax. Generally, income which is paid out to a beneficiary currently (or required to be paid out) is taxed to the beneficiary. On the other hand, income retained in the trust is generally taxed to the trust. A typical example would be capital gains, which are ordinarily considered principal and not distributed.

Certain fully revocable trusts of which the Grantor is a co-trustee, and certain other trusts, need not file separate income tax returns. The Grantor reports the income directly on his 1040, and all trust assets are held under the Grantor's Social Security Number.

We suggest that an attorney or accountant prepare your 1041's for you. Although they are short, they are different from ordinary income tax returns in several ways. In the case of very simple trusts, the individual trustee may be able to prepare the returns after the first year by following the example of the first return.

ACCOUNTINGS AND TERMINATION; RELEASE OF THE TRUSTEE

Trustees traditionally exonerate themselves from beneficiary complaints every few years by submitting an account of their transactions. Such accountings can be extremely detailed and usually require professional preparation. It is very important that all trust records be retained to facilitate the preparation of the account.

In some situations it may be sufficient to submit the accounting to the beneficiaries and have each of them approve it. If the beneficiaries refuse to approve the trustee's informal account, or if the trust instrument or the law so requires, the trustee must submit the account to either the Surrogate's Court or the Supreme Court, which will adjudicate any dispute between the parties.

The trustee will also render an account when the trust terminates, or when the trustee resigns or dies.

MISCELLANEOUS

A. The Distinction Between Income and Principal

Traditional accounting rules divide trust assets into "income" and "principal." Usually principal is the amount initially received from the donor plus any appreciation, certain stock splits and stock dividends, and capital gains (net of tax). Income consists of certain dividends, interest, rents, royalties, and other regularly recurring receipts. In unusual cases, distinguishing principal from income can require the advice of a professional and a thorough review of the law.

Unless the trust instrument requires otherwise, expenses as well as receipts must be properly divided between principal and income items. Typically, court costs and attorneys fees are allocated to principal. Bank trustee fees, investment advisor fees and custody costs are allocated one-third to income and two-thirds to principal, under New York law. In some situations, expenses are charged entirely to income or principal. For example, if the trust owns a rental property, expenses should be divided as follows:

| Expense - - Paid From: | Income | Principal |
|------------------------|--------|-----------|
| Property Insurance | X | |
| Property Taxes | X | |
| Repairs & Improvements | | X |
| Maintenance | X | |
| Utilities | X | |

Because some expenses offset income it is not possible simply to have the income beneficiary receive automatic remittances of all dividends and interest. The trustee will need to withhold some part of the trust income for the payment of those expenses allocable to income.

B. "In Solido" Administration of Similar Trusts

Often several separate but equal trusts will be set up to provide, for example, for several children. Each trust may start with the same assets and be subject to the same terms and conditions. In such case, the trust instrument will often allow the trustee to invest all the trust funds in a single investment account for convenience, with

each beneficiary receiving a fraction of the income. This procedure is called administration "in solido".

Nevertheless, the trusts are separate entities. Even with in solido administration, separate tax I.D. numbers and separate tax returns are required for the trusts. Fortunately, as long as the trusts are handled identically, the tax returns will be identical except for the I.D. number.

In solido administration is impractical if the needs of the beneficiaries differ - for example, if some need principal distributions and others do not, or if some need to invest for low risk and others do not. Before one trust differs from the others in any way it should be broken out and placed in a separate investment account.

C. Successor Trustees

The trust instrument will often name a successor trustee. It may also provide that the acting trustees may name their own successors. Trustees should be familiar with these provisions of the instrument and, if necessary, should promptly name a successor on a standby basis so that the trusteeship is never vacant. If no trustee is effectively named, the Surrogate's Court will choose a trustee.

D. Compensation of Trustees

In New York, trustees are entitled to commissions for their services. For individual trustees, commissions are based on statutory fees schedules.

Though long, the foregoing advice is far from complete. We urge you to discuss trust administration with a professional prior to undertaking any trusteeship. We will be glad to answer your questions.

DAVIDSON, DAWSON & CLARK LLP
60 East 42nd Street, 38th floor
New York, New York 10165
(212) 557-7700

Rev. 1/07