Trusts&Estates

The **Public's Interest** in Charitable Trusts: Unsettled Issues

BY AMY F. ALTMAN AND KRISTIN BOOTH GLEN

Charitable institutions, by definition, are created for the benefit of the public. Often, they are beneficiaries of trust instruments.[1]

Yet the ordinary protections enjoyed by private trust beneficiaries against trustee misfeasance are currently unavailable to the "public" as beneficiary, even when trustees seek to modify, through a cy pres proceeding, the terms of a charitable trust instrument that is more than a century old.[2] The doctrine of cy pres allows trustees to change the method of pursuing the trust's mission when its current means becomes "impractical or impossible."[3] Trustees must demonstrate not only that administration of the trust is impracticable but also must propose an alternate plan that is "cy pres comme possible," meaning "as near as possible" to the original intent of the founder.[4]

Three cases involving cy pres and charitable enforcement issues raise important questions about who can protect the public interest in charitable trusts, and perhaps as important, when. They are: a cy pres proceeding involving the District of Columbia's oldest private art museum and college devoted to the arts, the Corcoran Gallery of Art and the Corcoran College of Art + Design (the Corcoran); a similar proceeding involving the Barnes Foundation in Philadelphia (the Barnes); and a petition filed by the Committee to Save Cooper Union to prevent the board of trustees of Cooper Union from charging tuition (the Cooper Union).

The Cooper Union, above, and **the Corcoran Gallery of Art and College of Art + Design**, are two institutions involved in proceedings that raise important questions about who can protect the public interest in charitable trusts, and when.

WIKI (2)

Corcoran Litigation

In 1869, William Corcoran, a wealthy businessman, established Washington, D.C.'s oldest private art museum. In the deed of trust Corcoran expressed "a long cherished desire to establish an institution in Washington City to be 'dedicated to art' and used solely for the purpose of 'encouraging American genius.'"[5] The Corcoran Gallery's original art works, acquired from Corcoran's private collection, have been deemed one of the greatest collections of American art ever assembled. Corcoran later funded the Corcoran College of Art + Design (the College), which promoted students' access to the collection. In 1890, the trustees acquired land across from the White House for a new building, known as the Flagg building, which houses the Gallery and College.[6]

The Corcoran trustees filed a cy pres petition seeking to merge the Gallery with the National Gallery of Art (NGA), which would take over the collection, and its College (including the Flagg building) with George Washington University (GW), which would operate under the GW name.[7] The trustees alleged deterioration of Corcoran's overall financial condition due to a lack of wealthy dedicated donors, thus compromising maintenance and preventing the upgrade of an aging building, and financial impossibility in continuing to operate the Gallery and College. Strict guidelines of the American Association of Museums and the Association of Museum Directors requires proceeds from art sales to be used solely to acquire other art, so no part of the collection could not be sold to fund maintenance or operations without risking the Museum's accreditation and reputation in the art world.

> The doctrine of **cy pres** allows trustees to change the method of pursuing the trust's mission when its current means becomes **"impractical or impossible."**

In June, students, faculty and alumni of the College, and a not-for-profit, Save the Corcoran, comprised of donors and former students, moved to intervene. They sought to prevent the trustees from what they claimed amounted to a complete eradication of the Corcoran institutions, alleging misconduct and maladministration by the trustees who, they argued, had committed a grave breach of fiduciary obligations in their attempt to "destroy the very institution that they were charged with protecting." Numerous charges of mismanagement included the sale of the building's parking lot, in a no-bid process for less than market value, a costly year-long unsuccessful pursuit of an agreement with the University of Maryland, and a decline in fundraising that "didn't just happen" but was the direct result of the board's general "malaise" and lack of vision. The controversy also had potential human consequences, including layoffs for staff of the Gallery and College and tuition hikes for students seeking a degree from the College, as opposed to GW.

The Superior Court granted intervention only to students and faculty, applying the special interest test discussed below, and held a day hearing on the cy pres issue with testimony from 11 witnesses. In late August, he issued a 49-page decision, describing as "painful" his ruling in favor of the merger and meticulously enumerating why he believed the GW/NGA proposal was consistent with William Corcoran's original intent.[8] He noted that the Flagg Building would be renovated; the College would continue under a financially sound university » Page 10

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Planning a Bequest of a Closely-Held Business Interest to a Private Foundation

BY CATHERINE B. EBERL AND NATHAN W.G. BERTI

Private foundations are an appealing planning tool for the charitably inclined closely held business owner. A gift or bequest to a client's private foundation allows the client or his estate to obtain an upfront tax deduction, while allowing the family to continue to control the asset.

However, when the bequest is an interest in a closely held business, the private foundation excise tax rules may prohibit the foundation from owning the interest long term. As such, a plan to bequeath an interest in a closely held business to a private foundation necessarily requires consideration of whether the foundation will need to divest itself of the interest after the client's death, and if so, how that divestment will occur.

The federal government subjects private foundations to strict administration rules, frequently referred to as the private foundation excise taxes. As opposed to a public charity, which receives contributions from a wide base of donors, private foundations generally receive contributions from only one donor, or from several donors who are members of the same family. Frequently, the donor and the donor's family frequently control the foundation. Because the donors are also the foundation managers, historically there was a perception of widespread abuses of the private foundation structure. As a result, Congress enacted the excise tax regime, subjecting private foundations to strict rules intended to ensure that the foundation's assets are used only for charitable purposes.

The excise taxes are implicated when a "disqualified person" enters into a transaction with the foundation. Under IRC §4946, a substantial contributor to the foundation is a disqualified person. So are foundation managers and owners of more than 20 percent of the total combined voting power of a corporation that is a substantial contributor to the foundation, owners of more than 20 percent of the profits interest of a partnership that is a substantial contributor to the foundation, or owners of more than 20 percent of the beneficial interest of a trust or unincorporated enterprise that is a substantial contributor to the foundation. In addition, family members[1] of a substantial contributor, a foundation manager, or 20 percent owners are all disqualified persons.

Certain entities are also considered disqualified persons. A corporation will be » Page 10

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Developments, Lessons And Reminders Of 2014

BY SHARON L. KLEIN

From landmark legislation, to important regulatory guidance to instructive case law, 2014 saw many significant New York developments, lessons and reminders.

1. Public Access to Surrogate's Court Documents Limited: New Surrogate's Court Rule.

By Administrative Order dated Feb. 19, 2014, a new Surrogate's Court rule was adopted,[1] which limits public access to certain documents. The rule attempts to strike a balance between two competing interests: public access to judicial proceedings and privacy concerns. By their nature, filings in Surrogate's Court proceedings often contain confidential identifying and financial information. To protect privacy and enhance security given the dangers of information misuse (including identity theft), the new rule limits access to certain documents. Only interested parties (including potential beneficiaries and their counsel, public administrators and court personnel) can view: Guardianship proceeding filings pursuant to Surrogate's Court Procedure Act Articles 17 and 17A, death certificates, tax returns, documents containing social security numbers, inventories of firearms and inventories of assets. Others can view these records with written permission of the Surrogate or Chief Clerk, which permission cannot be unreasonably withheld. Media groups have voiced opposition to the new rule on the basis that court documents should be presumptively open to the public.

On Nov. 6, 2014, a new redacting requirement was adopted for certain confidential personal information contained in civil filings in Supreme and County courts.[2] Compliance under the new rules will be voluntary for filings from Jan. 1 to Feb. 28, 2015, but mandatory thereafter. Those rules, which were adopted after the Surrogate's Court rule, do not apply to filings in Surrogate's Court. Given the fact that media groups have voiced opposition to the Surrogate's Court rule and the fact that the redaction rule in Supreme and County courts represents a later and different approach to address the same types of concerns, the Surrogate's Court rule is now being reviewed in light of those developments.

2. Disposition of Digital Assets: Approval of Uniform Law Leads to State-Level Momentum.

As digitization in our modern world explodes, the ownership, transfer and disposition of digital assets present unprecedented challenges. Digital assets encompass social media websites such as Facebook, email accounts such as Yahoo, personal accounts like Shutterfly and financial accounts. Family members can face many challenges in unlocking a decedent's digital information, including establishing their rights to access that information, and retrieving confidential user IDs and passwords. Terms of Service (TOS) Agreements with individual providers (which are typically entered into by clicking "I agree" when opening) usually govern what happens to an account on the death of the owner. Often, they can provide that the account is not transferable and all rights to the account cease on death. Federal and state laws that criminalize unauthorized access to computers and prohibit the release of electronic account information can prevent fiduciary access to the digital assets.

> A new Surrogate's Court rule was adopted which **limits public access to certain documents.** The rule attempts to strike a balance between two competing interests: public access to judicial proceedings and privacy concerns.

The Uniform Fiduciary Access to Digital Assets Act (UFADAA) was approved by the Uniform Law Commission (ULC) on July 16, 2014. The goal of the UFADAA is to remove barriers to a fiduciary's access to electronic records by reinforcing the concept that the fiduciary "steps into the shoes" of the account holder. The UFADAA uses the concept of "media neutrality:" If a fiduciary would have access to a tangible asset, the fiduciary will also have access to a similar type of digital asset. "Digital asset" is very broadly defined to mean a record that is electronic. The UFADAA:

- Goes beyond the estate situation and covers four common types of fiduciaries: personal representatives, guardians, agents acting under a power of » Page 8

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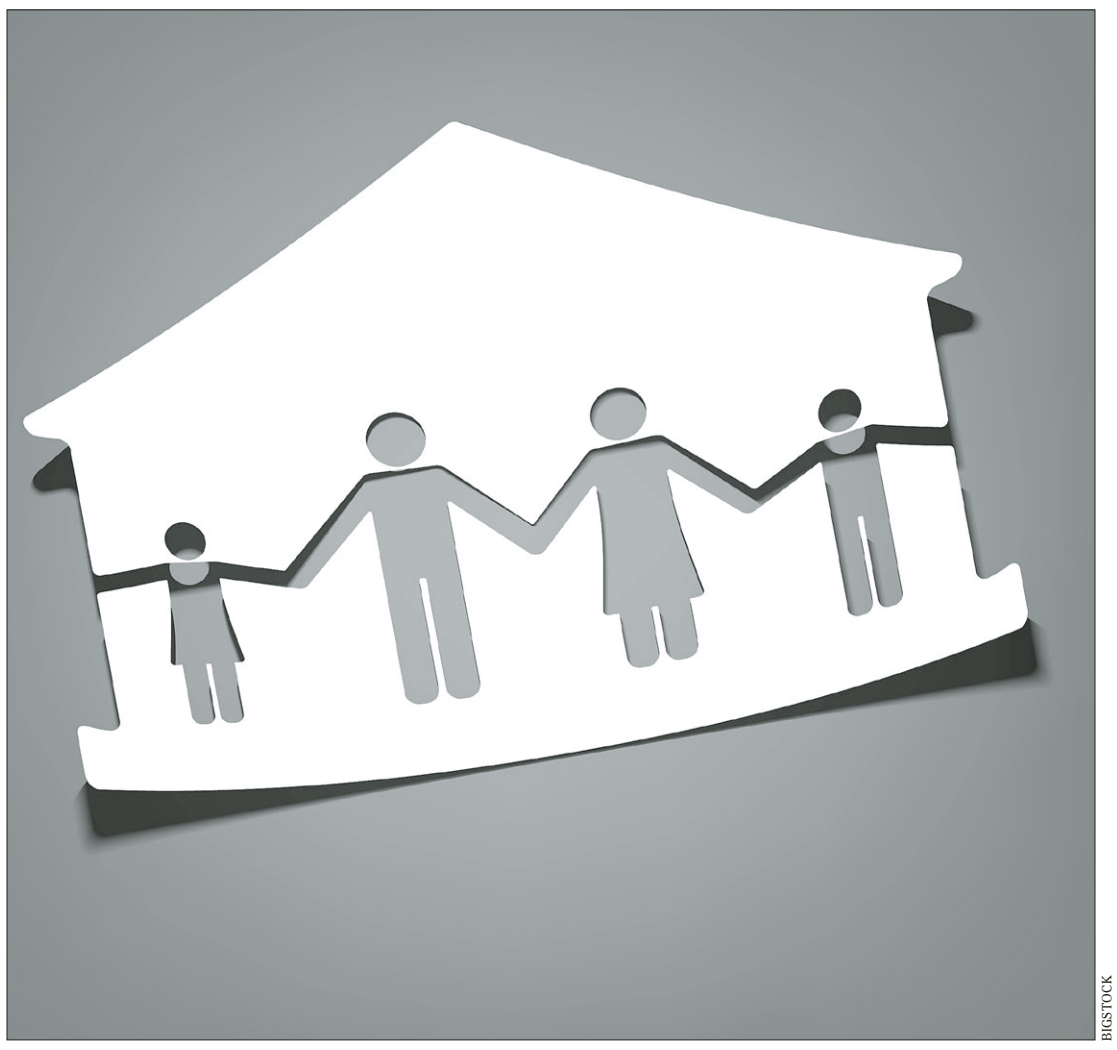
Inside

Mediation Makes Estate Planning, Administration **More User Friendly**



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BY LESLIE J. WILSHER

In 2011, the New York State Bar's Dispute Resolution Section and the New York City Bar's Alternative Dispute Resolution Committee conducted an online survey about mediation. The respondents had good things to say about the mediation process.

In addition to recognizing the relative economic efficiency of mediation, these lawyers appreciated that it tended to produce a resolution more quickly than litigation, that it focused on resolution rather than conflict, that it was confidential and that it promoted settlement by providing participants with a more realistic view of their own position and of what they could expect from the dispute resolution process.[1]

Yet, despite its increasing popularity in matrimonial proceedings and many commercial contexts,[2] mediation does not appear to have caught on as a means of resolving probate, administration and similar estate- and trust-related disputes. This is something of a paradox. The estate planning and administration practice area is enmeshed in human interaction and fraught with emotional issues; and mediation is able to accommodate the human element of a dispute in ways that are unavailable in a courtroom.

In mediation, the parties speak for themselves. Among other things, this allows them to say things that might be irrelevant as a matter of law, but are important to the resolution of the dispute at hand. In an actual mediation case held at the New York Peace Institute, two young women, apartment mates, were reiterating the innumerable annoying and inconsiderate things the other had done. The sub-lessee complained, among other things, that the lease-holder was making too many rules, and the lease-holder complained that the sub-lessee was making too much noise. Nothing either woman said had any bearing on who had the legal right to remain in the apartment. But mediation gave the rule-maker the opportunity to explain her need for lack of clutter in the living room; and the noise-maker was able to explain that a damaged eardrum prevented her from using headphones. As the discussion proceeded and each responded to the other's complaints, they both came to a surprising realization: Much of the other person's lack of consideration was a matter of the complainant's own perception. Each woman recognized that she had been projecting malicious intent onto the other based on their mutual dislike and the assumption that the other was acting with the express purpose of causing irritation. This "aha!" moment not only cleared the air, it also cleared the path to an agreement on several major issues regarding use of the common areas in the apartment.

Similarly, when disputes arise in the course of an estate administration, they invariably have more to do with conflicting emotion-laden undercurrents than the subject at hand. For example, when siblings fight over their parents' personal effects they frequently perceive that far more is at stake than ownership of the items themselves. Often, particular items have special emotional significance. Joshua Harmon provides a quintessential example of this in his play, "Bad Jews," in which two of the decedent's grandchildren fight over who is entitled to inherit "Pappi's Chai." Is it Daphna, for whom Jewish culture and its symbols have become fundamentally important? Or is it Liam, who wants to give the chai to his fiancée in lieu of a ring, just as his Pappi did when proposing to his grandmother? The dispute disintegrates into physical violence, and the audience is left to muddle the problem out for itself.[3]

Alternatively, the participants may disagree over process—the older sibling "always took the best stuff," or the baby of the family "got whatever he wanted." Perhaps they have been in competition with each other since their childhood and always argue over everything; or perhaps they simply hate each other and cannot agree upon anything. Personal issues between disputants frequently get in the way of resolving disagreements. Lawyers create the mechanisms for handling these disagreements, but they do not always work and they often are not cost effective.[4] If one sibling is simmering over something the other did or the way the siblings were treated by their parents, a process of alternate selection will be unsatisfactory, at best, and fodder for a major blowout, at worst. When an emotional or family dynamic issue is impeding the dispute resolution process, addressing that issue is the surest means of moving the process along.

Mediation also offers a degree of flexibility in handling concerns about confidentiality. In a traditional dispute resolution setting, participants are reluctant to admit to anything that might weaken their legal position, and the lawyers must consider whether divulging particular pieces of information might have that effect. Mediation favors the free exchange of information; and a mediation agreement should contain a confidentiality provision that encourages such an exchange. Although there will be exceptions,[5] what is said in mediation should remain within the confines of the process. This allows participants to speak freely, without fear that—should the matter ultimately end up in court—something they say will come back to haunt them later. Free exchange of information enhances clear communication, which in turn corrects misunderstandings and opens up avenues for conflict resolution.

For example, one of the issues for the antagonistic apartment mates was missing food. Because the mediation forum encouraged discussion, one of them admitted to taking some of the other's food from the shared refrigerator. She explained that she was going through an especially difficult time economically, and confessed to being ashamed of her actions. The other apartment mate had assumed the food was taken out of spite or, at the very least, lack of consideration. She was still angry that her food had been stolen—after all, finances were tight for her, too. But she appreciated the honesty and the apology, and responded sympathetically. Thus, the exchange removed an obstacle in their effort to finds ways to live together harmoniously.

For the most part, traditional lawyering is about taking a position, based on one or more legal theories, and demonstrating that it is correct and that the other side's position is incorrect. Most settlement negotiations similarly begin with opposing positions, while the lawyers go back and forth, attempting to find places where compromise can be reached. This zero-sum process assumes that the only way one side can achieve its goals is for the other side to make concessions.

Mediation looks to the interests that lie behind positions. Instead of assuming their interests are opposed, participants can explore possible areas of common interest or, at least, ways in which both of their interests can be accommodated without compromise.[6] In an actual case, the decedent's children wanted access to the decedent's garage, and the decedent's live-in girlfriend didn't want them going into the garage. Instead of arguing about who had the right to enter the garage, counsel asked each other questions designed to elicit information about the clients' underlying concerns. Why did the children, who had their own homes, need access to the garage? Why did the girlfriend, who had no reason to use the garage, not want the children going in there? The answers were straightforward. The children needed access to the grandchildren's bicycles and other items they had stored in the garage. The girlfriend was badly frightened one evening when she heard unexpected noises coming from the garage and would have called the police had she not realized the children were the source of the noises. Knowing what each side really wanted—access to stored items, not being frightened at night by strange noises—made finding a solution simple. An access schedule and notification system allowed each side to obtain what it needed; and neither side had to give up anything to get it.

> When disputes arise in the course of an estate administration, they invariably have **more to do with conflicting emotion-laden undercurrents** than the subject at hand.

Just as it does not utilize the zero-sum approach to problem resolution, mediation does not focus on determining who is right and who is wrong. Communication flows more freely when the participants are not worried about being judged on their conduct. The food-stealing apartment mate is a case in point. If the discussion leads to an apology on one person's part, a mediator will make certain the other person heard it. But the mediator will not decide whether or not the apology was warranted; and the other person will be free to accept it or not. Constructive problem solving means spending time and energy on seeking a solution, rather than on laying blame and determining who was at fault.

Last September, Vikings running back Adrian Peterson raised a commotion when the media learned that he disciplined his four-year-old son with a switch. In response to public outcry, the National Football League increased a one-game suspension to extend the entire season. Countless members of the media weighed in on the debate about Peterson's actions and the League's response, expressing everything from outrage at the severity of the child's injuries to empathy for Peterson's own brutal childhood. There were as many points of view as there were participants in the discussion. So, who was right and who was wrong? Peterson pled guilty at his criminal trial in exchange for community service and a fine, but that only speaks to whether or not he abused his child under applicable law and how the judge saw fit to punish him. Neither Peterson's guilty plea nor the media's focus on right and wrong solves the underlying issue for Peterson, whose parents apparently taught him a limited approach to child discipline,[7] or for the National Football League, which is under pressure to determine what kind of policy, if any, it should adopt in these cases.

Mediation encourages the parties to look for their own solution, instead of having one imposed on them. This approach is based on the premise that a person is far more likely to work toward, and adhere to, a solution when he or she has participated directly in the decision-making process. It is the grown-up version of giving the recalcitrant toddler a choice between the red sweater or the blue one, instead of saying, "You have to wear a sweater!" The toddler can assert herself by making the sweater selection, rather than being forced to assert herself by saying, "No!" Similarly, a self-constructed solution invariably will be more palatable than one imposed by a court.

Looking to the participants for the solution also leaves more room for thinking outside of the proverbial box and customizing the solution to fit their individual situation. In an estate dispute, the history of the participants goes back for decades and includes countless private nuances. No matter how much fact-finding occurs, the participants always will have the most intimate knowledge about the issues and their background. Similarly, the participants also will know best what, for them, would help to resolve those issues. Encouraging them to be creative without—at least initially—being evaluative can be very productive.

Ultimately, a client may insist on having his day in court, but feel very differently when faced with the experience. Until they have been through it, most non-lawyers do not realize how time-consuming and exacting the litigation process is. They are not used to taking into consideration factors such as busy court calendars, rules of evidence and courtroom procedure. The reality—including that nothing is resolved in the space of a one-hour television drama—is likely much more stressful and emotionally draining than they imagined.

Mediation is a voluntary process and, for non-lawyer consumers, much more user-friendly. Participants need not feel as if they have lost control over timing once discussions are underway. They can stop the proceedings at any time, without making a motion to withdraw and without prejudice to the options available for continuing. Breaks can be taken when needed, instead of when permitted. Overall, the process looks and feels more like a conversation. Plain English is spoken; and there's no cross-examination and re-direct. There are no rules of evidence because neither side has anything to prove. If they wish, participants can agree on their own rules for the process, such as whether mobile phone interruptions will be permitted. Perhaps most important where comfort level is concerned, no one is imposing judgment on their words or their past actions. The goal is not to determine who is right, but to find a solution that suits everyone at the table.

Every family has its dynamics; and every estate practitioner has witnessed how, especially after the death of someone who was "keeping the family together," old family patterns—resentment, jealousy, competition, coercion—rise to the fore. From a legal perspective, many of these family matters are irrelevant or unhelpful to the client's position. However, they may be of utmost importance to the client and, by extension, to the smooth administration of the estate.

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1. "Mediation Through the Eyes of New York Litigators," Report of the Mediation Committee of the New York State Bar Association Dispute Resolution Section and the Alternative Dispute Resolution Committee of the New York City Bar Association, Feb. 17, 2011.
2. See, e.g., Thomas J. Stipanowich and Ryan Lamare, "Living with ADR: Evolving Perceptions and Use of Mediation, Arbitration, and Conflict Management in Fortune 500 Companies," Harvard Negotiation L. Rev., Vol. 19, 2013.
3. The Roundabout Theater Company, which produced this particular production, hosted a wall on which audience members could post their individual thoughts. The author's response? They needed mediation.
4. In one case handled by my former firm, the legal fees for completing the process of alternate selection by conference call and the work leading up to it cost several multiples of the value of the property itself.
5. Lawyers, even when acting as mediators rather than as counsel to a party, must be mindful of the Code of Professional Responsibility, Title 22, NYCRR, Part 1200; social workers, mental health professionals and many others are mandated reporters of child abuse or neglect under New York State law, Title Six, Social Services Law, Article Six.
6. See, e.g., Roger Fisher and William Ury, "Getting to Yes: Negotiating Agreement Without Giving In," second edition, Penguin Books, 1991.
7. Perhaps fortunately for Peterson and his son, League Commissioner Roger Goodell directed Peterson to meet with New York psychologist April Kuchuk to develop a counseling program.

Top 10

« Continued from page 7

attorney and trustees;

- Maneuvers around federal and state privacy and computer fraud/abuse laws by defining fiduciaries as authorized users; and
- Supersedes any contradictory TOS agreements: Provisions in TOS agreements broadly barring fiduciary access are void.

Upon the written request of a fiduciary with authority over digital property, a custodian must comply with the fiduciary's request for access, control or a copy of that property within 60 days. Custodians are granted immunity from taking any action in compliance with the statute.

After receiving the ULC's approval, a uniform act is officially promulgated for consideration by the states, and legislatures are urged to adopt it. A uniform law is not effective until a state legislature adopts it, sometimes with state-level massaging. Now that a final version of UFADAA has been released, it is reasonable to expect a flurry of state activity as individual legislatures are expected to introduce legislation based on it. Various professional organizations in New York are currently collaborating to finalize a New York version of UFADAA for introduction in the next legislative session.

3. Unitrust Regime: A Reminder About the Availability of Retroactivity.

The precepts of the Prudent Investor Rule govern the investment of trust assets. Pursuant to those precepts, a trustee is required to invest for "total return," in order to benefit both income and principal beneficiaries. However, when beneficial interests clash, the source of return becomes critical, and the tension between investing for income and investing for growth can become more pronounced. The power to adjust[3] and unitrust regimes[4] can provide trustees with the means to implement the mandate of total return investing, in effect, by preempting the definition of fiduciary accounting income. Under the power to adjust regime, the trustee is permitted to make adjustments between income and principal to be fair and reasonable to all beneficiaries. Under the unitrust regime, a trust can be converted to a unitrust, pursuant to which the income beneficiary will receive a fixed 4 percent payout of the trust's principal.

Matter of Kruszewski[5] is an instructive reminder that, in New York, a retroactive application of the unitrust regime is possible. In December 2011, the sole income beneficiary of a testamentary trust created by his father commenced a proceeding seeking to apply retroactively New York's unitrust provisions. In a summary judgment application, he requested that the court either not specify the effective date or, alternatively, set the effective date as Jan. 1, 2002 (the effective date of the unitrust option in New York). The Surrogate found that the income beneficiary was barred by the doctrine of res judicata[6] from seeking unitrust payments prior to the date of a final decree settling a former trustee's accounting, but that in any event a Jan. 1, 2012 effective date was appropriate. In making that determination, the Surrogate considered various factors, including the fact that the beneficiary had consented to the accounting, thereby acknowledging that the sums paid to him were proper, and that the Jan. 1, 2002 retroactive date would trigger significant tax consequences and significantly reduce the principal of the trust to the detriment of the income and remainder beneficiaries.

On appeal, the Appellate Court noted that the court determines the unitrust effective date, the selection of which is a matter committed to the sound discretion of the Surrogate's Court. Regardless of whether the Surrogate properly invoked the doctrine of res judicata, the Appellate Court held that the factors considered by the Surrogate were entirely appropriate, and that a Jan. 1, 2012 effective date struck an appropriate balance between providing the beneficiary with a reliable source of income during his retirement, while minimizing the detrimental effect of the unitrust conversion.

Although the court did not grant retroactivity, the discussion of factors it considers in making that determination is instructive. The fact that that retroactivity could be appropriate is implicit in the decision. Contrast this potential for retroactivity with the statutory language regarding the power to adjust, which appears to apply prospectively only:

> [T]he prudent investor standard also authorizes the trustee to adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make appropriate *present and future* distributions … EPTL §11-2.3(b)(5)(A) (emphasis added).

Accordingly, for those seeking a retroactive regime, the unitrust option in New York might be very appealing. New York is in a distinct minority in allowing retroactive application of the unitrust regime:[7] Most states allow prospective unitrust payments only. In the right circumstances, a beneficiary seeking retroactive payment might consider moving to New York a trust governed by another state's laws.

4. Revisions to How Interest on Delayed Legacies Is Computed: Legislation Finally Enacted.

After many years brewing, New York has finally enacted a new law regarding how interest is computed on delayed legacy payments.[8]

Under prior law, unless the will provided otherwise, 6 percent interest was payable on a testamentary pecuniary legacy that was unpaid seven months after letters issued. The interest charge was payable only if a legatee made a demand for the interest before initiating a judicial proceeding.

The new law makes three main changes:

1. Interest is automatically payable on a pecuniary legacy unpaid within seven months from the issuance of letters.

According to the legislative summary, the dual requirements for demand and a judicial proceeding have not been applied consistently. This caused a great amount of uncertainty, leaving fiduciaries in the difficult position of potentially paying interest on a legacy at their peril in the absence of a judicial proceeding, or forcing an unnecessary, expensive judicial proceeding.

2. The interest charge will be tied to the federal funds rate.

The former fixed statutory interest rate of 6 percent was too high based on current market rates, but might be too low in a different economic environment.

3. The interest charge is recharacterized as accounting income, so that its payment will carry out distributable net income and generate a deduction for the estate.

Although reportable as income by the legatee, the interest was not previously deductible to the estate.

The new law applies to estates of individuals who die on or after Dec. 20, 2014.

5. You Can Divorce a Spouse, But Not Necessarily the In-Laws: Lesson and Reminder.

At issue in *Matter of Lewis*[9] was Estates, Powers and Trusts Law (EPTL) §5-1.4. That section provides that divorce revokes dispositions to, and fiduciary nominations of, former spouses, but the revocatory effect of the section does not extend to the *relatives* of an ex-spouse.

In *Lewis*, the decedent executed a will in 1996, nine years prior to her divorce. The will left her entire estate to her husband, who she also appointed as executor. In the event the decedent's husband predeceased her, she named his father as the alternate executor and alternate beneficiary

» Page 11

Can Wills and Trusts Be **Contest-Proofed?**

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BY TERENCE E. SMOLEV AND CHRISTINA JONATHAN

Over the past several years, there has been a substantial increase in the amount of will contests and trust contests in the various Surrogate's Courts of the State of New York.

This increase relates to the fact that demographics of families have changed considerably. There are multiple spouses with first, second, even third marriages and children from this multiplicity of marriages, not to mention children who are born out of wedlock. As a result, the ex-spouses and stepchildren very often have disagreements over family matters, financial matters and other issues which give rise to contests of a decedent's estate.

While this article is meant to discuss contest proofing testamentary documents, the results of a contest can never be guaranteed. In New York, there are generally three grounds in which an interested party may contest a will: (1) that the testamentary instrument was improperly executed, (2) that the testator was not mentally competent, and (3) that the will was a product of fraud or duress. Here, we will discuss some of the procedures that practitioners should follow to defensively assist clients with their estate planning, so as to minimize a potential will contest. In addition, the same procedures should take place relative to living wills, and other documentation that may be required such as family limited partnerships, personal residence trusts, Grantor retained annuity trusts, grantor retained income trusts and possibly the establishment of a family foundation.

The primary responsibilities of an estate planning practitioner is to assist the client in minimizing estate taxes and probate expenses and, most importantly, to assist as much as possible in making sure that the testamentary documents executed by the client, which directs his or her last wishes, be executed in such a manner that the will shall withstand any objections to probate.

It is very important that the practitioner, when dealing with estate planning for a client, follow certain procedures in every single estate planning matter, regardless of how well the practitioner knows the client, the business relationship between the practitioner and the client and the familiarity that the practitioner has with the client's family members. Everything the practitioner does in the estate planning field should be based upon defensive actions for the benefit not only of the client, but also for the attorney and staff, when and if a contest does in fact arise. The more complete the practitioner's notes, files, and their showing of revisions of the testamentary instruments prior to the actual execution of a finalized document, the more it helps to deter actual court contests. The practitioner should never shortcut the estate planning process, which includes the careful procedures in having the testamentary documents prepared and executed, because failing to follow certain procedures may be a key factor in exposing the decedent's estate to attack by one or more of the decedent's heirs.

Specifically, the practitioner should meet with the client alone and with no other person except possibly an assistant, paralegal or other attorney from the practitioner's firm. Copious notes should be taken at that initial meeting, wherein the practitioner should ask and record questions and answers about the client's health, mental capacity, and reasons why the client desires certain provisions to be placed in the testamentary documentation, which may have an adverse interest on one or more of the heirs, including a surviving spouse.

After the initial meeting with the client, the practitioner should create a confidential memorandum, which should be shared with the client outlining all of the conditions and terms that the client discussed regarding the estate planning documentation and the contents thereof. Included in this memorandum should be a recitation about the client's assets, medical and mental conditions, and the planned disposition of his or her assets. The client should be given a copy of this memorandum and should discuss that memorandum with the practitioner at a second meeting. It is suggested that at the second meeting not only should the practitioner be present but again an assistant, paralegal or other attorney from the firm, who will take additional notes for the file regarding the client's discussion relative to the terms and conditions of the memorandum.

Once the second meeting has taken place, the documents should be drafted for the client based upon the information gleaned from the meetings. That draft document should then be provided in advance to the client for review. Once examined, the third, and most times final meeting should take place with the client with final copies of the testamentary documents available, so that the client may execute the same. The various testamentary documents are comprised of a will and/or a living trust, health care proxy, living will, power of attorney and a disposition of remains, which directs the named representative as to where and how to dispose of the client's body upon death.

In the event that the client wishes to make any additional changes in the testamentary documents, it is generally advisable that the practitioner keep all prior drafts in the computer or in the files, for purposes of defending a contest relative to the testamentary documents. Each draft should be saved with the new date it was revised, to track all changes the client has requested.

Furthermore, if there is any reason to believe the client's mental capacity will be challenged in a will contest, it is highly recommended that the practitioner utilize extra preventative methods and/or services, such as arranging for a legal videographer to be present during the meetings and execution of documents. A professional legal videographer includes a stenographer as well, so your client will have the safeguards of a video and transcript. During the execution ceremony, the practitioner should explain in the video who each person is in the room, he should have the client read the will aloud, acknowledging his comprehension of each paragraph therein verbally and he should make sure he thoroughly questions the client to ensure that this is his or her final wish upon demise.

If the practitioner is drafting testamentary documents for both a husband and wife, or domestic partners, there should be a joint representation document signed by the clients stating that they understand that the practitioner is representing both of them, is meeting with both of them and will be drafting testamentary documents for both of them. The joint representation document should include statements that both clients understand that there is no attorney-client privilege as to and between anything discussed privately by either client with the practitioner. This is very important so that in the event there is ever a will contest by one of the married individuals, or the partners, there cannot be any claims that the practitioner violated attorney-client privilege or did not advise both parties as to the status of the representation. That letter should be signed not only by the practitioner but also by both clients.

Another valuable means of attempting to contest proof testamentary documentation is to suggest to the client that family meetings should be held with open discussions regarding the estate planning that the client wishes to undertake. Sometimes families ask that the practitioner be present at these meetings. It is important that the practitioner take notes as to the discussions at the meeting, and the planned outcome from those discussions. It is generally our advice that an assistant, paralegal or another attorney attend the family meeting with the practitioner. Basically, we are preparing for a potential will contest, having notes as to who said what, when and where for use in defending a potential contest.

> Everything the practitioner does in the estate planning field should be based upon **defensive actions** for the benefit not only of the client, but also for the attorney and staff, when and if a contest does in fact arise.

Also note that some practitioners are under the impression that inserting an in terrorem clause in the client's will in and of itself shall detract contests. Basically, an in terrorem clause, also known as a "no-contest clause," generally provides that if the beneficiary of a testamentary instrument unsuccessfully challenges the instrument's validity, then that beneficiary forfeits his or her bequest. The major oversight with this clause is that if your client wishes to disinherit a beneficiary completely, then that beneficiary has nothing to lose by challenging the validity of the testamentary instrument with an in terrorem clause, since he or she was not entitled to anything in the first place. A good recommendation to make for potential hostile beneficiaries is not to disinherit. Rather, leave a bequest that is sufficient enough for the beneficiary so that they are in fear of losing the same if they decide to challenge the testamentary instrument.

Typically, the larger the size of the estate, the more protection is needed to safeguard your client against potential contests. An infamous case in New York involved the late Brooke Astor, whose net worth was over $198 Million. Astor was a New York City philanthropist and socialite, who passed away at the age of 105 in 2007.

Unfortunately, the feuding over Astor's Estate commenced well before she even passed away, during several "hotly-contested Article 81 proceedings concerning the health, care and finances of society icon Brooke Astor."[1] Herein, Astor's only son, Anthony D. Marshall had various powers of attorneys and health proxies; however, Astor's grandson, ironically the son of Anthony D. Marshall, petitioned the court » Page 10

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Charitable

« Continued from page 7

umbrella; the College and a majority of the collection would remain in the Flagg Building; and the Gallery, albeit smaller, would be open to the public. One important but overlooked point is that under the original deed, if the trust's purpose was no longer viable, the property reverted to Corcoran's heirs, a result that, if enforced, may not have been to either side's advantage. The intervenors chose not to appeal. Unlike an accounting proceeding, there was no determination as to whether the trustees were responsible for the situation, or liable for damages. A scenario policy question remains: What if anything, could have been done to prevent circumstances from deteriorating to the point of requiring cy pres, and by whom?

Barnes Litigation

Albert Barnes, like Corcoran, was a successful businessman who accumulated perhaps the foremost individual collection of impressionist, post-impressionist and early modern European art. Rejecting Barnes' visionary taste, the downtown Philadelphia aristocracy considered his collection unimportant, even vulgar, so Barnes determined to ensure it would never be shown in downtown Philadelphia or especially near the Philadelphia Museum of Art, which he called "a house of artistic and intellectual prostitution." Barnes intended to create an educational institution for students, not a public museum or tourist attraction. To that end, he bought land and built a gallery to house the art in Lower Merion, a Philadelphia suburb. The deed of trust was explicit, restricting the sale or loan of any of the works and limiting the public's access. Decades after his death, however, trustees sought cy pres to allow the collection to go on tour, and to permit more public admission.[9] In the equivalent of a corporate takeover, new trustees who were members of three powerful foundations and Philadelphia's elite pledged to raise money in exchange for additional seats on the Barnes Foundation board. They subsequently sought to move the entire collection to a building in downtown Philadelphia adjacent to the Philadelphia Museum of Art.[10]

In 2004, donors, friends, and alumni created a not-for-profit, Friends of the Barnes, that attempted to halt the move to downtown Philadelphia based on new evidence that $100 million of state funds were covertly allocated toward the Barnes move; the Montgomery County Orphan's Court denied them standing, leaving their claims unaddressed.

Who Is the Public?

Corcoran and Barnes are examples of a wider problem: How, if at all, are the public's rights to be represented in charitable trust enforcement cases? Although the beneficiaries of private trusts are clearly defined, beneficiaries of a public charity, whether formed by a trust instrument or incorporated, are unidentified, creating legal uncertainty.[11] Recognizing that the concept of standing may be needed to prevent unnecessary "vexatious" litigation by uninterested parties, the question of who is an "interested" person when a charity was created for the benefit of the public is more problematic.[12] Who then has standing to represent the public? Only someone closely tied to the charitable purpose? Is it anyone? Should the term "public" be read restrictively or expansively? A thoughtful article in last year's New York Law Journal Trusts & Estates Special Report addressed donor standing to enforce restrictions on charitable gifts; we ask whether the public, as beneficiary, is adequately represented, and how, if at all, the public's interest can be advanced and protected prior to the need for cy pres.[13]

Attorneys General

New York, like many states, deems the Attorney General (AG) the representative of the public, in charge of the management and enforcement of charitable institutions.[14] There are, however, inherent problems in an AG's enforcement of charitable interests. First, AG offices have many important and competing obligations and are often understaffed and underfunded.[15] Equally, an AG may be responsive to political interests and pressures, perhaps disinclined to investigate a prominent board of trustees, or board members who were political donors.[16] A documentary on the Barnes case, "The Art of the Steal," suggested that the Pennsylvania AG may have been persuaded by a governor who favored the move in order to create a tourist attraction in the heart of Philadelphia.[17] Like many other states, Pennsylvania does not afford private citizens standing to sue to enforce a charitable purpose. If AGs are questionable representatives to enforce trust provisions against trustees, who can or should? This issue warrants greater attention.[18] There are several possibilities.

> These cases bring to the foreground important, unsettled issues, not only in **affording adequate representation** of the public's interest in cy pres cases like Corcoran and Barnes, but also in **charitable enforcement cases** like Cooper Union.

Relator Actions, Derivative Suits

Some states, such as California and Massachusetts, have passed statutes allowing relator actions to aid the AG's enforcement of charities. A relator is a party permitted to proceed in the name of the public or the AG when the legal power to sue rests solely with the AG.[19] A relator may take an active role and must pay litigation costs but cannot sue if the attorney general declines to proceed.[20]

For charities created by nonprofit corporations, members of the organizations have been generally recognized as having an interest in the entity, with the right to bring derivative suits to enforce a charity's purpose, similar to a shareholder's right in a for-profit corporation.[21] Such representatives of the "public," however, may not truly reflect the interests of the broader public. And, of course, they are inapplicable in privately created public trusts.[22]

Special Interest Doctrine

When applied liberally, the most useful method of allowing private individuals to stand in for the public is the special interest doctrine.[23] Does the party have a specified "interest" or "stake" in the charity? If a party qualifies, then it can become the representative for all charitable beneficiaries. Generally, courts look to the remedy sought, the nature of the acts complained of, the presence of bad faith, the suitability of the AG as an available and effective party and the nature of the benefitted class and its relationship to the charity.[24] Potential plaintiffs must either be members of a small, identifiable class, or persons or entities directly harmed by a breach of the trust. The nature of the plaintiff's interest in the charity is the key element and was used in the Corcoran case to determine that current students, employees and faculty had a direct economic stake in the merger and thus special interest.[25] Application of the special interest doctrine varies from state to state, with some applying it liberally while others, like New York, use a more narrow construction.

New York's Narrow Application

The special interest doctrine was first adopted in the court's decision in *Alco Gravure v. Knapp Foundation*, which held that a mere member of the public or possible beneficiary is "not entitled to sue for enforcement of the trust."[26] The plaintiffs were only granted standing because they are entitled to a preference in the distribution of funds and the class of potential beneficiaries were sharply defined and limited in number.[27] Lower courts have continued this restrictive interpretation.

New York's Cooper Union is currently embroiled in a battle to determine, inter alia, whether a group of students, alumni and tenured faculty, The Committee to Save Cooper Union have standing to sue its trustees for the 2013 decision to begin charging tuition and to enforce the 1859 deed of trust by Peter Cooper which, they argue, established the university as "free to all who shall attend." The committee is also seeking an accounting from the trustees.[28]

The trustees' have challenged the committee's standing, arguing that the New York AG is the only party with standing to enforce founding documents and that the special interest doctrine is inapplicable because the committee is not "a limited, well-defined group of beneficiaries with a preference to the charitable assets of Cooper Union." The committee responded that students and faculty constitute a "limited number" of persons, and, unlike the general public, they have a "tangible stake in the matter." This matter is currently sub judice.

Conclusion

The lack of public accountability by charitable institutions and the historic resistance to allow individuals legal standing as public beneficiaries has been widely recognized.[29] The Corcoran and Barnes cases demonstrate situations where cy pres was essentially a fait accompli. By the time the petitions reached the court, it was too late, for financial reasons, to continue in the same vein. The only remaining questions were which proposal best met the grantor's intent but, perhaps more important, not how the situations became so grave as to warrant cy pres. Cooper Union presents an effort, albeit belated, to avoid such drastic results. These cases bring to the foreground important, unsettled issues, not only in affording adequate representation of the public's interest in cy pres cases like *Corcoran* and *Barnes*, but also in charitable enforcement cases like Cooper Union. Thoughtful consideration, including the possibility of legislative action, may well be warranted.

1. Unif. Trust Code §405(a).
2. Restatement (Second) of Trusts §391, cmt. d.
3. EPTL §8-1.1(c).
4. The Law of Trusts and Trustees §431 (3d ed. 2005).
5. An Act of Congress in 1870 incorporated its Board of Trustees and directed the Board to uphold the trust set forth under the deed.
6. In 1925, Sen. William Andrews Clark left his vast art collection to the Corcoran which expanded to create the Clark Wing.
7. *Trs. of the Corcoran Gallery of Art v. District of Columbia*, 2014 D.C. Super. LEXIS 17 (D.C. Super. Ct. 2014).
8. Id. at 84.
9. *In re Barnes Found.*, 2004 Pa. Dist. & Cnty. Dec. LEXIS 344 (Pa. County Ct. 2004).
10. Id.
11. The Law of Trusts and Trustees §411.
12. *Alco Gravure v. Knapp*, 64 N.Y.2d 458, 466 (1985).
13. See John C. Novogrod & Annie L. Mehlman, "Standing to Enforce Restrictions on Use of Charitable Gifts," 251 N.Y.L.J. 9 (2014).
14. Restatement (Second) of Trusts §391, cmt. a.
15. Mary Grace Blasko, et al., "Standing to Sue in the Charitable Sector" 28 U.S.F. L. Rev. 37 (1993).
16. Id.
17. "The Art of the Steal" (IFC Films 2010).
18. See Blasko et. al. and Evelyn Brody, "Whose Public? Parochialism and Paternalism in State Charity Law Enforcement," 79 Ind. L.J. 947 (2004).
19. Blasko, et al. at 49.
20. Permitting relators may supplement enforcement for under-resourced AGs, there are significant limitations such as the cost of litigation and the AG remains in total control and can settle, withdraw or dismiss the action at any time.
21. Blasko, et al. at 53.
22. Other states have allowed special "commissions on charitable organizations," which make policy recommendations but rely on the AG to take legal action.
23. Restatement (Second) of Trusts §391 cmt. c.
24. Blasko, et al. at 52.
25. Id.
26. See *Alco Gravure,* 64 N.Y.2d 458 at 465.
27. Id. See *Citizens Defending Libs. v. Marx*, 2014 N.Y. Misc. LEXIS 2491 (N.Y. Sup. Ct. May 30, 2014).
28. The concept of recovering funds on the basis of directors and officer's liability insurance is intriguing; however, many D&O policies exclude non-pecuniary actions, where plaintiffs file suit against a board for not fulfilling its mission.
29. James J. Fishman, "Improving Charitable Accountability," 62 Md. L. Rev. 218 (2003).

Bequest

« Continued from page 7

considered a disqualified person if more than 35 percent of the voting power is owned, directly or indirectly, by a disqualified person. A partnership is a disqualified person if more than 35 percent of the profits interest is owned, directly or indirectly, by a disqualified person. A trust or estate is a disqualified person if more than 35 percent of the beneficial interest is held, directly or indirectly, by a disqualified person. In addition, the I.R.C. §267(c) constructive ownership rules apply for purposes of analyzing the 20 percent and 35 percent ownership thresholds.

If a client intends to leave an interest in a closely held business to his or her private foundation, the planner should analyze whether the bequest would cause the foundation to have "excess business holdings" pursuant to §4943 of the Code. A private foundation and its disqualified persons, collectively, may not own more than 20 percent of the voting stock of a corporation. This number is increased to 35 percent if the foundation and all of the disqualified persons, acting together, do not effectively have control over the corporation. So long as disqualified persons do not own more than 20 percent of the voting stock (or 35 percent, if disqualified persons do not effectively have control over the corporation), a private foundation may own an unlimited amount of a company's nonvoting stock. Similar rules apply to interests in partnerships and limited liability companies.

Several exceptions apply to the excess building holdings rules. First, an interest in a business that is "functionally related" to the mission of the foundation will not be considered excess business holdings. In addition, a foundation will not run afoul of the excess business holdings rules if 95 percent or more of the gross income of the business is passive.

Passive income includes dividends, interest, and royalties, and in many cases, rent. Finally, the Code provides a de minimis exception for ownership, granting a reprieve from the excise tax for a private foundation that does not own more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock in the business.

If the private foundation exceeds the percentage holdings noted above, the private foundation has "excess business holdings" and must divest itself of the excess holdings or face an excise tax equal to 10 percent of the value of the excess business holdings. If the tax is assessed and the excess business holdings are not disposed of, the tax increases to 200 percent.

For illustrative purposes, assume that a client owns 100 percent of a family business. At death, he intends to give 100 percent of the voting stock to his child who works in the business; 60 percent of the non-voting stock to his children, equally; and 40 percent of the non-voting stock to the private foundation that he created and funded during his lifetime. His motivations are both charitable and tax driven, as he hopes that the charitable deduction will negate the need to raise liquidity to pay estate taxes, allowing the business to remain in the family for the next generation.

This bequest will cause the foundation to have excess business holdings. The client is a substantial contributor to the foundation, and as such, he and his children are all disqualified persons. The foundation and all disqualified persons may not own more than 20 percent of the outstanding voting stock in the corporation. Because the one child intends to retain 100 percent of the voting stock, and the foundation's holdings exceed 2 percent of the value of the business, the foundation will have to divest itself of the bequest of 40 percent of the non-voting stock.

Having determined that the foundation will have excess business holdings, the client and planner should consider the plan for divestment. If the foundation has excess business holdings and no way out, a charitable deduction may have saved the company from a fire sale to pay the estate tax only to result in a company that may be seriously stressed by, and may not survive, an excess business holdings crisis.

A sale or redemption in the estate would be the simplest way to cure the excess business holdings problem. Assuming the executor can overcome the legal impediments to a sale or redemption, as discussed further below, there may still be major practical impediment if the client did not plan in advance for the divestment: A sale or redemption is only possible to the extent that there is readily available cash or other assets. If a redemption is desired, the company may have to deplete its cash on hand or exhaust its line of credit in order to complete the redemption, which could cripple the ability of the company to continue to operate on an ongoing basis. Or, if the preferred route is for the decedent's family to purchase the stock, consideration should be given as to how those individuals will fund the purchase price.

If a sale to the client's children is contemplated, the excess business holdings must be sold by the estate, as opposed to by the foundation. As a result, the time frame for the sale is limited to the years immediately following the client's death. The sale must occur in the estate because a child of a substantial contributor is a disqualified person, and the self-dealing rules found in I.R.C. §4941 flatly prohibit the sale of foundation assets to disqualified persons, even if the sale is for fair market value.

Similarly, if the plan is for the company to redeem the excess business holdings, the redemption must occur in the estate and not in the foundation. In this example, the company itself is also a disqualified person, generally making the redemption a prohibited I.R.C. §4941 self-dealing transaction, too. There is one exception to the redemption prohibition: A redemption is not considered self-dealing if all of the securities of the same class as that held by the foundation are redeemed on the same terms, and the terms provide for receipt by the foundation of no less than fair market value. In many cases, such a widespread redemption will be neither feasible nor desirable.

> A plan to **bequeath an interest in a closely held business** to a private foundation necessarily requires consideration of whether the foundation will need to divest itself of the interest after the client's death, and if so, how that divestment will occur.

The executor's sale to a disqualified person, or redemption by a disqualified person, is considered an indirect act of self dealing, and therefore is only permissible if the executor meets the requirements laid out in Treasury Regulation §53.4941(d)-(b)(3). First, the executor must possess a power of sale with respect to the stock, have the power to reallocate the stock to another beneficiary, or be required to sell the property under the terms of any option subject to which the property was acquired by the estate or trust. In addition, the foundation must receive an amount equal to or greater than the fair market value of the foundation's interest or expectancy in such stock at the time of the transaction, and the transaction must be approved by the probate court having jurisdiction over the estate, the trust, or the private foundation.[2] The transaction must occur before the estate or trust is considered terminated for federal income tax purposes. And finally, the transaction must result in the foundation receiving either an interest at least as liquid as the one it gave up or an asset related to the active carrying out of the foundation's exempt purpose.

If the executor does not take advantage of this procedure in the estate and instead transfers the excess business holdings to the foundation, the foundation will be stuck with limited options to rid itself of the excess, such as by distributing the shares to a public charity or by selling the shares to an unrelated third party. In addition, the foundation will only have five years to dispose of the excess before it becomes subject to the excise tax, a grace period that is allowed to foundations that acquire excess business holdings as a result of a gift or bequest. The clock starts to tick not on the decedent's death but when the estate or trust administration has completed and the business holdings are actually transferred to the foundation. This period can be extended for an additional five years in the case of an unusually large gift or bequest of diverse business holdings with complex corporate structures if: (1) the private foundation establishes that diligent efforts were made to dispose of the excess holdings, but the holdings could not be disposed of due to size, complexity, or diversity; (2) the private foundation submits a plan for disposal of the assets within the second five-year period; and (3) the IRS approves the plan.

The excise tax rules are not the only tax consideration to the foundation continuing to own an interest in a closely held business. Even if it is determined that the foundation's holdings are not excess business holdings, the foundation may be subject to the I.R.C. §511 unrelated business income tax (UBIT) on the income earned from the business. The concept of UBIT is simple—an otherwise tax-exempt entity should have to pay tax on income from a trade or business that is unrelated to the entity's exempt purpose, just like any other taxpayer. The exempt entity must pay income tax on unrelated business income at standard corporate or trust tax rates, as applicable.

Unless a specific exception applies, income is treated as unrelated business income if the following three factors are met: (1) the income is from a trade or business; (2) the trade or business is regularly carried on; and (3) the trade or business is not substantially related to the organization's exempt purpose. The term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services. Although it might otherwise fall within the definition of a trade or business, a foundation's passive income is generally not subject to UBIT.

Special attention should be paid to interests in an S corporation that a client plans to bequeath to his or her private foundation. When a foundation owns S corporation stock, the stock is automatically treated as an interest in an unrelated trade or business, and all flow-through items of income, loss, or deduction, and any gain or loss on the sale of the stock, are subject to UBIT. This is true regardless of the character of the flow-through income as passive income at the S corporation level. By holding the S corporation interest, the foundation is essentially wasting its tax-exempt status, subjecting itself to income tax it would otherwise not have to pay if it sold the S corporation stock and reinvested in other assets. Identifying this issue in the planning stage may cause a client to reconsider the bequest to the foundation, or perhaps to put in place a plan to change the business tax and corporate structure after the client's death.

A client's decision to bequeath an interest in his closely held business to his private foundation is only the first step. If the client intends for the business to continue on to the next generation, careful analysis and planning is required to determine whether the foundation can own the interest, how the foundation will divest itself of the interest, and how the foundation will be taxed if it continues to own the interest. Many of these nuances may come as a surprise to the client who thought that he was proposing a straightforward bequest. If the issues are not addressed and planned for when the estate plan is put in place, it will fall upon the executor to come up with a solution, and, by necessity, the solution may deviate dramatically from the client's intentions.

1. Family members is defined broadly to include spouses, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren.
2. In New York, this court proceeding is typically in the form of a Petition for Advice and Direction under §2307 of the Surrogate's Court Procedure Act. The New York State Attorney General's office is an interested party to the proceeding and must approve the terms of the proposed sale or redemption.

Contest Proof

« Continued from page 11

to remove his father and void these documents. The issue boiled down to Astor's mental capacity. Needless to say, the fighting between the father and son carried forward once Astor passed away, tying up the distribution of her estate. Ultimately, the New York County Supreme Court found Anthony D. Marshall guilty of fraud and conspiracy charges against Astor's estate, as well as first-degree grand larceny. He was sentenced to one to three years in prison in 2009, which was affirmed on appeal. According to a New York Time's Article dated Dec. 1, 2014, Anthony D. Marshall served two months in Fishkill Correctional Facility in 2013, before he was approved and released for medical parole. He recently passed away on Nov. 30, 2014, at the age of 90.

Astor's case is one of many that encompasses elder abuse, duress, fraud, and stealing of assets. This is why it is extremely important for the practitioner to safeguard his client's final wishes by following the tips herein. Again, following these procedures does not guarantee that there will not be a contest; however, contests are unlikely to survive if the attorney draftsman has extensive notes documenting the client's mental condition, demeanor and most importantly directions upon his or her demise, with the reasoning therein.

1. *In re Phillip Marshall*, 14 Misc.3d 1201(A), 831 N.Y.S.2d 360 (Table), 2006 WL 3615041 (N.Y.Sup.), 2006 N.Y. Slip Op. 52365(U).

Top 10

« Continued from page 8

of all her property. While they were married and residing in Texas, the couple bought from the decedent's parents New York real property that had been in the decedent's family for generations. When the couple divorced in 2007, the property was awarded to the decedent, who relocated there permanently until her death in 2010.

No will was found by the decedent's family after her death, and her parents were awarded letters of administration. They renounced their interest in the decedent's New York property so it would pass to her brothers. After her ex-husband learned of her death, the decedent's former father-in-law offered the 1996 will for probate. The decedent's parents and brothers objected, but a divided Appellate Division affirmed the Surrogate's holding to dismiss the objections. According to the majority, the statute is clear and unambiguous in omitting the relatives of an ex-spouse, even "if we could assume that the ex-husband might someday inherit or obtain the property from [his father]."

In a strongly-worded dissent, the dissenting judge pointed out that the ex-husband's claim to be "shocked" to discover that his father was the decedent's sole beneficiary was "simply incredible"; that the evidence suggested that the ex-husband's family hid the will until they learned of the decedent's death about 8 months after her passing when her ex-husband "decided to Google [decedent's] name [to] see … what came up and her obituary came up"; and that the father-in-law was petitioner in name only, the true party in interest being the ex-husband, who was barred under EPTL §5-1.4 from taking under his former wife's will. According to the dissent, admitting the 1996 will to probate was "manifestly unjust and inequitable … [and] would defeat the purpose and spirit of EPTL §5-1.4."

Several professional organizations are currently reviewing whether EPTL §5-1.4 should be revised. Although Texas law was inapplicable in *Lewis*, that state's probate code provides that, after divorce, all will provisions (including fiduciary appointments) must be read as if the former spouse *and each relative of the former spouse who is not a relative of the testator* predeceased the testator.[10] The Uniform Probate Code revokes testamentary bequests to the former spouse, as well as bequests to the former spouse's relatives.[11] Another approach might be to have a rebuttable presumption that relatives of an ex-spouse are excluded, although that would result in uncertainty compared to a bright line rule. Any rule would of course be a default rule, subject to contrary expression.

And therein lies the reminder and the lesson: Divorced spouses must give immediate attention to their planning documents, to ensure they reflect their intent.

6. Enforceability of Charitable Pledges: A Lesson for Charities.

Despite judicial acknowledgement of the widely recognized public policy favoring enforcement of charitable pledges, the court in *Estate of Kramer*[12] refused to enforce a decedent's $1,800,000 pledge and promissory note (together, the subscription). The subscription, in furtherance of a building project at the Educational Institute Oholei Torah—Oholei Menachem, was signed in August 2006, and the decedent died in February 2008. According to the court, the rationale underpinning enforcement of a pledge is based on the theory of unilateral contract: A pledge is not a contract, but an offer to contract, which, when acted upon by incurring liability, becomes a binding obligation. Accordingly, the question before the court was whether the charity accepted the subscription by acting in reliance thereon, the burden being on the charity to demonstrate prima facie reliance. The court identified three sets of cases where charitable pledges had been enforced by the courts:

1. Those where substantive progress had been accomplished towards the charitable purposes for which the pledges were received (such as where a building was actually built or construction was underway or a construction loan was obtained);
2. Those where partial payments in satisfaction of the pledges were made (acceptance of which created a bilateral contract); and
3. Those where facts demonstrated actions in reliance by the donees, as well as partial payment by the donors (such as where partial payment for a construction project had been paid and the building had been constructed).

In *Kramer*, the court found that the charity failed to demonstrate the required "proof of meaningful and substantive actions in reliance [of the subscription]:" The charity had not begun construction, had not engaged any building professionals and had not incurred any legal, financial or contractual obligations with respect to the building project, which the court described as "a hoped-for occurrence, an expectation of uncertain fruition."

This case should serve as an important reminder to charities that, without support to establish the requisite legal relationship, they cannot assume that a signature on a pledge card will be enforceable.

7. Recognition for Children Born After the Death of a Genetic Parent: Legislation Enacted.

As a result of scientific advances, a child can be conceived after the death of one or both of the child's genetic parents with stored genetic material. With continued technological developments and increasing demand for sophisticated storage techniques—Facebook and Apple, for example, announced that they will pay for their female employees to freeze their eggs—the number of children born after the death of their genetic parents can only be expected to rise. The law enacted on Nov. 21, 2014 clarifies the circumstances under which a child born after the death of a genetic parent will be considered a child of that parent for inheritance and succession purposes.[13]

Under the new law, a child will be considered a distributee of the genetic parent and a child of the genetic parent for purposes of class gifts in dispositive instruments, if the following four conditions are satisfied:

1. In a written instrument signed not more than seven years before death, the genetic parent must (a) expressly consent to the use of the genetic material for posthumous reproduction and (b) authorize a person to make decisions about the use of the genetic material after the genetic person's death (the statute includes a model form of written instrument, the authority under which is revoked by divorce);
2. Within seven months of the issuance of letters, the person authorized to make decisions must give notice of the existence of the stored genetic material to the personal representative of the genetic parent's estate;
3. Within seven months of the issuance of letters, the authorized person must record the writing in the Surrogate's Court; and
4. The genetic child must be in utero within 24 months or born within 33 months of the genetic parent's death.

With regard to dispositive instruments in which the genetic parent was not the creator, the provision is effective for wills of individuals dying after Sept. 1, 2014, or lifetime trusts executed after that date. For instruments created by the genetic parent, the law will apply regardless of date.

8. Statutory Residency: Landmark Court of Appeals Decision and New Nonresident Audit Guidelines.

New York generally taxes residents on their worldwide income. There are two separate and independent bases on which an individual can be taxed as a resident: (1) the individual is domiciled in New York or (2) the individual is a nondomiciliary who satisfies the statutory residency test. That test has two prongs: The nondomiciliary must (a) maintain a permanent place of abode in New York *and* (b) spend 184 days or more in the state during the taxable year.[14] There are two components of permanence that must be satisfied in order to establish that a taxpayer is "maintaining a permanent place of abode":

- Physical attributes of the dwelling; and
- Nature of the taxpayer's relationship to the dwelling.

"Physical attributes" has been interpreted to relate to the nature of the residence and whether it is *objectively* suitable for year-round living, not the taxpayer's actual use of it.[15]

Regarding the nature of the taxpayer's relationship to the dwelling, guidance is provided in the Nonresident Audit Guidelines, issued by the New York State Department of Taxation and Finance. The department issues the guidelines to ensure uniformity and consistency in the examination of nonresident returns. According to the guidelines themselves: "… they have no legal force or effect, but are generally binding on audit staff who are expected to follow the rules and procedures outlined in the guidelines when conducting an audit." The latest version of the guidelines was issued in June 2014.[16] The guidelines set out a list of seven factors to consider in evaluating the taxpayer's relationship to the dwelling: ownership, property rights, contribution to maintenance, relation to other occupants, registration for government or business purposes (such as mail, voter and car registration or phone service), dedicated separate space/personal items, and unfettered access.

> The law enacted on Nov. 21, 2014 clarifies the circumstances under which **a child born after the death of a genetic parent** will be considered a child of that parent for inheritance and succession purposes.

The statutory residence test was the test at issue in the landmark decision of *Gaied v. Tax Appeals Tribunal*.[17]

John Gaied was a New Jersey domiciliary who worked in New York. In 1999, he purchased a three-unit apartment building in New York. His parents occupied the first floor apartment, and he rented out the basement and second floor. He paid the expenses of the apartment for his dependent parents, who had no other means of support. He had no bedroom, or even a bed in the apartment, and kept no clothing or personal belongings there. When he occasionally spent nights at the apartment at the request of his parents due to their health concerns, he slept on a couch. Gaied did spend over 183 days in New York for business, so the matter turned on whether the apartment could be considered a permanent place of abode. The Tax Appeals Tribunal determined that he did maintain a permanent place of abode, finding it significant that he maintained and owned the property, and had unfettered access to it (despite his actual infrequent use). In a 3-2 decision, the Appellate Court ruled in favor of the Tribunal. Gaied appealed to the Court of Appeals, which examined the Tax Tribunal's interpretation of "permanent place of abode" as meaning that a taxpayer need not "reside" in the dwelling, but only maintain it. The review of the Court of Appeals was limited to whether that interpretation comports with the meaning and intent of the statutes involved. The court concluded that there was no rational basis for the Tribunal's interpretation. According to the court, a permanent place of abode must relate to the taxpayer. In other words, a mere ownership interest is not sufficient; there must be some basis to conclude that the residence was utilized as the taxpayer's residence:

> The legislative history of the statute, to prevent tax evasion by New York *residents* … supports the view that in order for a taxpayer to have maintained a permanent place of abode in New York, the taxpayer must, himself, have a residential interest in the property.

The most significant update between the 2014 Nonresident Audit Guidelines and the previous 2012 version is to memorialize the department's reaction to the Court of Appeals decision in *Gaied*. Surprisingly, the guidelines provide that the court's finding (that there must be some basis to conclude that the residence was utilized as the taxpayer's residence) is "consistent with current Audit policy that the taxpayer must have a relationship to the dwelling for it to constitute a permanent place of abode." The 2014 guidelines make it clear that possession of property rights and the making of contributions, while important aspects to be considered in evaluating a relationship to a residence, by themselves "would not necessarily make a dwelling a [permanent place of abode] *without more*." However, the examples given to illustrate the department's views seem to belie their assertion that their interpretation is consistent with the court in *Gaied*:

Example 1 describes taxpayers who occasionally use an apartment in New York City for cultural events, rather than driving back to their home in New Jersey. The department concludes: "A residence that is owned and maintained by a taxpayer with unfettered access will generally be deemed to be a permanent place of abode *regardless of how often the taxpayer uses it*." (emphasis added)

Example 2 describes a taxpayer who moves to Florida, lists her New York home for sale and no longer resides there. Because the taxpayer has unfettered access and "*no one else is using it as residence currently*" (italics in guidelines), the department concludes that the taxpayer retains a residential interest and that the home would constitute a permanent place of abode.

In Example 3, the department posits the same facts as Example 2, except that the home contents were moved to the Florida residence and the New York home was vacant. In those circumstances, the guidelines provide that the taxpayer would not have a residential interest in the New York home because it would not be reasonable to expect her to use a vacant home despite having unfettered access.

Example 4 closely mimics the situation in *Gaied*: Instead of John who lives in New Jersey, the guidelines posit Jim, who lives in Connecticut. Like John, Jim works in Manhattan, buys an apartment for his elderly mother, is the legal owner, pays all the expenses, has a key and occasionally sleeps on the couch when visiting. According to the department, despite the presence of a number of factors that would indicate it is a permanent place of abode—ownership, maintenance, unfettered access, actual use—the property does not constitute a permanent place of abode: "… the overriding point is that the residence is used *primarily* by the mother and the taxpayer's occasional use should not change its character."

Although Example 4 should give some comfort to those who hold legal title to property that is used by others (like parents who own an apartment occupied by a child), it seems clear that the department is still focused on the *ability* to use the property, rather than actual use. Query whether that view is really consistent with the Court of Appeals holding that, given the legislative history of the statute—"to prevent tax evasion by New York *residents*" (emphasis in original)—*there must be some basis to conclude that the residence was utilized as the taxpayer's residence*. Can property be utilized as a residence without actual use? In the Department's Example 2, query how unfettered access can be sufficient if a taxpayer does not actually use the residence?

9. Dramatic Fiduciary Income Tax Changes Effected with 2014-2015 Budget.

Perhaps the most dramatic changes of this legislative session were those effected on March 31, 2014, when the New York State legislature passed the Executive Budget for 2014-2015.

Under existing New York Tax Law, an income tax is imposed on the income of a "resident trust," which includes a trust created by a New York domiciliary. However, prior law provided that a resident trust would be exempt from tax if three conditions were met: (1) there were no New York trustees, (2) there was no trust property located in New York, and (3) there was no New York source income.

The Executive Budget includes changes to the taxation of resident trusts. While it does not impose a tax at the trust level, the new law does tax distributions of accumulated trust income to New York beneficiaries of these exempt resident trusts.[18] However, with capital gains apparently not subject to the accumulation tax and a number of potential strategies to reduce or eliminate the tax on accumulated income, establishing an exempt resident trust in a jurisdiction like Delaware can still be a very effective strategy for New York residents. Note also that the foundation for trust taxation in New York is the creation of a trust by a *New York testator or grantor*.[19] Except for source income, New York will generally not tax trusts created by *nonresidents*.[20] Accordingly, for residents of other states, New York is an attractive jurisdiction in which to consider creating trusts.

10. Dramatic Changes to Trusts & Estates Laws Effected with 2014-2015 Budget, and New York State Department of Taxation and Finance Guidance.

Estate Tax Exclusion Increases, But "Cliff" Impact Can Be Dramatic. The Executive Budget increases the New York estate tax exclusion amount over the next several years.[21] The exclusion amount was increased from $1 million to $2,062,500 for individuals dying after April 1, 2014. The amount increases to $3,125,000 for individuals dying after April 1, 2015, to $4,187,500 for individuals dying after April 1, 2016, and to $5,250,000 for individuals dying after April 1, 2017 and before Jan. 1, 2019. After Jan. 1, 2019, the New York exclusion amount will be linked to federal exclusion amount (projected in 2019 to be $5.9 million), including inflation indexing. However, the New York estate tax computation contains an estate tax "cliff": estates that are less than or equal to the New York estate tax exclusion amount will pay no tax, but the credit for New York taxable estates that are between 100 and 105 percent of the basic exclusion amount is rapidly phased out and eliminated entirely if the New York taxable estate exceeds 105 percent of the basic exclusion amount.[22]

On Aug. 25, 2014, the New York State Department of Taxation and Finance issued a Technical Memorandum[23] (TSB) to summarize and clarify the changes effected by the enactment of the Executive Budget. The TSB contains examples that illustrate the operation of the credit for an estate that is less than the basic exclusion amount (currently $2,062,500), and an estate that exceeds the basic exclusion amount by less than 5 percent, as follows:

Example 1: A taxable estate of $1,525,120 will pay no estate tax because the taxable estate is less than the basic exclusion amount. The applicable credit is equal to the amount of the tax.

Example 2: A taxable estate of $2,100,000 exceeds the basic exclusion amount by less than 5 percent, and is subject to a credit phase-out. The applicable credit is less than the estate tax due, resulting in a tax liability of $49,308.

What is not spelled out in these examples is the dramatic effect of the cliff. In the first example, a taxable estate of $2,062,500 would also have paid no tax, compared with second example of a $2,100,000 estate, which would have a $49,308 tax liability. The tax liability ($49,308) exceeds the increase in value from $2,062,500 to $2,100,000 ($37,500).

Also dramatic but not spelled out is the tax liability if the hypothetical estate was to exceed 105 percent of the basic exclusion amount ($2,165,625): An estate of $2,165,650 would have an estate tax liability of $112,052. As per the second example, an estate of $2,100,000 would have a $49,308 tax liability. The increased tax liability of $62,744 ($112,052 - $49,308) approximates the increase in value from $2,100,000 to $2,165,650 ($65,650). The increase in the value of the estate is almost entirely eaten up by taxes.

A Disappearing Estate Tax? Note that the estate tax may *disappear* after March 31, 2015: The estate tax rate schedule is expressed to apply to individuals dying between April 1, 2014 and March 31, 2015.[24] There is no rate schedule for individuals dying after March 31, 2015. Action is required to prevent the possible elimination of the estate tax for those dying outside the expressed timeframe.

Gift Add-Back. The New York gross estate of a deceased resident will be increased by the amount of any taxable gift made within three years of death, if the decedent is a New York resident at the time the gift is made and at the time of death.[25] Although New York estate taxes are generally deductible against the federal estate tax liability, the estate tax attributable to the gift add-back does not seem to be deductible under Internal Revenue Code §2058. The result is that gifts added back will potentially be subject to the full maximum 16 percent estate tax rate, without any offsetting federal deduction. The three-year look-back applies only to gifts made on or after April 1, 2014 and before Jan. 1, 2019. The way the budgetary language was drafted, there appeared to be a lack of parity with the estate tax regime: Gifts by a New York resident of out-of-state real property or tangible personal property were not specifically excluded from the gift add-back, but out-of-state real and tangible property are specifically excluded from the New York gross estate for New York estate tax purposes.

The TSB clarifies that gifts are not added to the gross estate if they consisted of real or tangible property having a location outside New York.

1. Uniform Civil Rules of the Surrogate's Court, Rule 207.64.
2. Uniform Civil Rules of the Supreme and County Courts, §202.5(e).
3. N.Y. Estates, Powers & Trusts Law (EPTL) §11-2.3(b)(5).
4. N.Y. EPTL §11-2.4.
5. *Matter of Kruszewski*, 116 A.D.3d 1288, 984 N.Y.S.2d 232 (3d Dept. 2014).
6. The doctrine of res judicata prevents claims being asserted after a judgment has been rendered.
7. California also appears to allow the unitrust regime to be implemented retroactively. See Cal. Prob. Code §16336.4(f).
8. New York A.1185/S.4952 (2013).
9. *Matter of Lewis*, 114 A.D.3d 203, 978 N.Y.S.2d 527 (4th Dept. 2014).
10. Tex. Estates Code §123.001
11. Uniform Probate Code §2-804 (1969, last amended 2010).
12. *Estate of Kramer*, N.Y.L.J., April 21, 2014 (Sur. Ct., Kings Co.)
13. N.Y. EPTL §4-1.3.
14. N.Y. Tax Law §605(b)(1).
15. See *In the Matter of the Petition of John J. and Laura Barker*, DTA No. 822324, 2012 N.Y. Tax Lexis 7 (N.Y. Div. Tax App. 2012).
16. 2014 Nonresident Audit Guidelines, State of New York—Department of Taxation and Finance, Income Franchise Field Audit Bureau (June 2014), available at www.tax.ny.gov/pdf/2014/misc/nonresident_audit_guidelines_2014.pdf.
17. *Gaied v. Tax Appeals Trib.*, 22 N.Y.3d 592, 983 N.Y.S.2d 757, 2014 NY Slip Op. 1101, 6 N.E.3d 1113 (N.Y. Ct. App. Feb. 18, 2014).
18. N.Y. Tax Law §612(b)(40).
19. N.Y. Tax Law §618. See 20 NYCRR §§118.1, 105.23.
20. N.Y. Tax Law §§631, 633; instructions to 2013 N.Y. Form IT-205 at 2. See N.Y. Tax Bull. TB-IT-615 (Dec. 15, 2011), available at www.tax.ny.gov/pdf/tg_bulletins/pit/b11_615i.pdf.
21. N.Y. Tax Law §952(c)(2).
22. N.Y. Tax Law §952(c)(1).
23. N.Y. TSB-M-14(6)M (May 15, 2014), available at www.tax.ny.gov/pdf/memos/estate_&_gift/m14_6m.pdf.
24. N.Y. Tax Law §952(b).
25. N.Y. Tax Law §954(a)(3).