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A Message from the Section Chair

Wallace Leinheardt

In my first column as Chair of our Section, I would like to look back and forward.

Back to thank my predecessor, Phil Burke, and the members of the Executive Committee for all of their hard work and accomplishments this past year.

Most significantly, we conducted a survey of our Section membership to learn what was most valuable to them and what we could do to improve and to attract new members. State Bar President, Kathryn Madigan, a member of our Section, has adopted as one of her goals to increase Association membership 10% and Section membership 15% in the next three years.

The survey also revealed interesting demographics about our Section members:

46% of our members are aged 56 and over, compared to 25% for the State Bar overall.

71% are 46 and over, compared to 46% for the State Bar. Our Section members are one-third female and two-thirds male.

Substantive suggestions included requests for more advanced and for more basic CLE programs (we can and will do both!). Members also suggested greater opportunities to network. Reduced membership and program fees were requested for retired and student members. The results noted a need to provide more information about and greater use of the Section Web site. The Executive Committee is considering a number of strategies to implement the needs and suggestions of our members.

I would welcome any input and volunteers for activities and projects you think the Section should do. I would also like to remind you that all Section members are invited to join Section committees that interest you. You can sign up at our Web site (www.nysba.org/trusts) or write to me at NYSBA. There are generally three or four organized committee meetings each year. An effort is being made to permit participation via teleconferencing or Web conferencing. Our *Newsletter* is a popular item with members. Our Editor, Austin Wilkie, is always looking for interesting and informative articles. Consider submitting something for publication. We expect to include in future issues "threads" from our Web page list serve.

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Looking forward, I have set some goals (in no particular order) for ’08.

One goal will be to increase membership, particularly with younger members. We will make a greater effort to recruit 2nd- and 3rd-year law students and 1st-year attorneys. We will be implementing a Mentor Program, connecting younger lawyers with experienced attorneys. We expect to have a program about retirement and transition planning for attorneys and their clients. We will be making recommendations concerning Practice Continuity—taking over a disabled or deceased attorney’s practice. The Executive Committee will also consider some form of a state-wide Will Registry database.

A second goal will be to review Mental Hygiene Law Article 81. A special subcommittee of the Elderly and Disabled Committee, headed by Robert Kruger, Anthony Enea and John Dietz, will examine how Article 81 can be improved upon, 14 years after its adoption.

Another goal seeks to collaborate with the New York Bar Foundation in finding worthwhile projects to fund with the Section surplus. An ad hoc committee led by Past Chair Michael O’Connor, and including Past Chairs, Tim Thornton, Warren Whitaker and Colleen Carew has met and suggested possible programs for summer interns, subsidizing CLE programs, Section sponsorship of District-wide networking meetings, as well as other projects. As part of that process and in order to better manage Section finances, a Finance Committee has been created under the leadership of our Treasurer, Betsy Hartnett. We are also considering the appointment of a “Budget Manager” as a semi-permanent position to review and formulate the Section’s budget in coming years. If you are interested in serving in that capacity, please communicate it to me.

Our Chair-Elect, Professor Ira Bloom, will be leading our goal to improve the Section by working with Committee Chairs to better organize the Executive Committee and in reviewing the Section’s outstanding legislative proposals.

Lastly—and my personal favorite goal—is for the Section to coordinate closely with the Office of Court Administration in connection with the bill adopted last year which extended OCA’s E-filing Pilot Projects in Surrogate’s Courts, to Chautauqua, Queens, and Suffolk Counties, in addition to Erie County. Joseph LaFerlita is our new Chair of the Special Committee on E-Filing. We are looking for “beta testers” who practice in those counties to assist us. I hope that by the time you read this, Erie County Surrogate’s Court’s E-filing Project will be operational. Imagine someday completing Surrogate’s forms in HotDocs®—hitting a button and they’re filed.

I want to invite anyone interested in participating in any of the above activities to contact me at techair@nysba.net, or just write me with your thoughts.

Wallace Leinheardt

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New Excise Tax on Unrelated Business Taxable Income of Charitable Remainder Trusts: Pitfalls and Planning Opportunities

By Mitchell Drossman

The past several years have seen a decrease in the popularity of charitable remainder trusts (CRTs). Presumably, the reduction in the capital gains rates and the near-historic lows in the Section 7520 rate have been contributing factors.

With the pending sunset of the low capital gains rates and the ever-increasing possibility of a raise in rates by a Democratic-controlled Congress, the use of CRTs should increase. Last year Congress gave a push in that direction by changing the way CRTs are taxed when they incur unrelated business income.

This article will review the general rules for CRTs, but will focus specifically on the change in the law that now permits CRTs to incur unrelated business income without jeopardizing the entire trust's tax-exempt status. The change in law opens the door for trustees to consider trust investments that previously seldom, if ever, were incorporated into a CRT's investment allocation. These investments—hedge funds and private equity, among other alternative assets—have been embraced by many institutional clients and have been of increasing interest to sophisticated individual investors. As a result of the change in the law, opportunities also exist for funding CRTs with assets previously avoided at all costs. However, without fully understanding the nature and tax character of the anticipated return of a particular investment, the new rules can actually produce results that are more tax onerous than under the old law.

In General—Charitable Remainder Trusts

A charitable remainder trust is an irrevocable trust that pays a specified amount (no less than 5% and no more than 50% of the value of the trust) of its assets each year to one or more non-charitable recipients for a specified term, at the end of which the remaining assets in the CRT pass to one or more charitable organizations (Charity or Charities). It should be noted that the creator or donor of the CRT can be a Non-charity, but often is an individual. In typical CRTs, the donor would create a trust and retain a stream of payments for a specified term and then, upon the expiration of such term, the Charity receives the remainder interest.

CRATs and CRUTs

There are two types of CRTs. CRTs that pay a fixed amount (based on the initial fair value of assets transferred to the CRT) are known as charitable remainder annuity trusts (CRATs); CRTs that pay a stated percentage (based on the annual fair market value of the CRT's assets) are known as charitable remainder unitrusts (CRUTs). There are variations on these CRTs, such as NIM-CRUTs (Net Income with Makeup), NI-CRUTs (Net Income) and FLIP-CRTs. The administrative, tax and other rules regarding CRATs and CRUTs are similar; however, there are some differences. Thus, for the most part, we will discuss CRTs, except where the differences are noteworthy.

Several technical requirements also must be met before a trust can qualify as a CRT. For instance, the anticipated value of assets that pass to Charity at the end of the term must equal or exceed ten percent (10%) of the initial value of the trust assets. The majority of the rules are designed so that Charity will receive the benefit of the assets remaining in the trust at the end of the term.

Most often, the choice between a CRAT or CRUT depends upon the donor's desires regarding distributions from the trust, as well as his or her outlook on the economy. If the donor wants a stable return, a CRAT is generally preferred since it yields a constant payout; if the donor believes that the assets will appreciate and wants to participate in the appreciation, then a CRUT is generally preferred since the annual payments will increase as the value of the portfolio increases.

Tax Benefits of CRTs

Assuming all of the technical requirements are met, the donor of a CRT established during life receives a federal income and gift tax deduction for the present value of the charitable interest. The deduction is subject to the same adjusted gross income (AGI) limitations applicable to all charitable gifts, depending upon the type of donated asset and the type of Charities anticipated to receive the property under the CRT. If a CRT is created at the time of one's death, then the decedent's estate would be entitled to an estate tax deduction.

While the CRT itself is tax-exempt, annual distributions to the beneficiaries during the term of the trust will likely have some tax characteristics depending on the activities of the trust.[1]

Donors of lifetime CRTs also receive potential economic benefits due to the tax-efficient growth of assets within the CRT. CRTs are generally exempt from federal income tax. This allows the trustee to sell ap-

preciated trust assets without triggering an immediate capital gain. Thus, if a single appreciated asset such as real estate, or a non-diversified portfolio with appreciated assets, is transferred to a CRT, it allows the trustee to sell such assets and diversify the portfolio, without triggering an immediate capital gain.

Unrelated Business Taxable Income—A "Ding" of the Past

As mentioned above, CRTs are generally exempt from federal income tax. However, before the passage of the Tax Relief and Health Care Act of 2006 (2006 Act) and prior to its effective date of January 1, 2007, if the CRT had even $1 of unrelated business taxable income (UBTI), the trust would lose its tax exemption for that tax year. Congress changed this onerous rule in late 2006 and passed a much more favorable and sensible rule. The new rule has opened up investment opportunities for CRTs, particularly with the use of so-called alternative investments (hedge funds, private equity, among others); created interesting opportunities for funding CRTs with partnerships conducting business; and created several pitfalls that could result in a more onerous tax than under the old laws.

UBTI is taxable income derived from investments in trade or business activities held in pass-through entities, such as a publicly traded limited partnership interest in an operating business. Investments that use leverage or have been acquired through the use of leverage (technically known as debt-financed property) will also produce UBTI. Hedge funds and rental real estate pose a particular risk of producing some UBTI.

Old Law

The old law eliminated the CRT's federal tax-exempt status for any year that the CRT generated UBTI, even $1, forcing the trust to pay tax on the entire amount of its net income for that year. As a result, the CRT would be taxed as a "complex" trust, with an allowable DNI deduction for amounts required to be distributed to the beneficiary. Any remaining income would be subject to income tax at appropriate trust tax rates.

Example 1: A CRT has $5 million of investment assets, consisting of $4.5 million of stocks and bonds and $500,000 of rental real estate. The stocks and bonds generate $340,000 of income and the real estate generates $60,000 of income, of which $20,000 is UBTI. The CRT is required to pay 5%, or $250,000, to its donor. Prior to the 2006 Act, the CRT would pay tax on its net undistributed income of $150,000 ($400,000 of income less its DNI deduction of $150,000) due to the presence of only $20,000 of UBTI. At top marginal rates, the trust would owe approximately $50,000 in federal income taxes.

Because of this onerous provision, CRTs generally did not invest in any assets producing UBTI, unless such investment holdings were structured in a highly sophisticated manner.

New Law

The 2006 Act modified the old law by removing the loss of income tax exemption and, instead, imposing a new excise tax equal to the amount of the UBTI: in sum, a 100% tax on the CRT's UBTI income. Accordingly, any net undistributed income is no longer subject to income tax.

Example 2: Using the same facts as in Example 1, under the new law, the UBTI would be taxed at 100% on its UBTI income, so that the CRT would pay $20,000 in excise tax, but no income tax beyond that, for a net tax savings of $30,000.

Initial Funding Year—Significance and New Opportunities

The change in the law is especially significant, and perhaps more dramatic, at initial funding. Most CRTs are created by a donor who wants to sell a highly appreciated asset without incurring current capital gains tax. Consider the following example under both the old and new law.

Example 3: Assume a donor has a highly appreciated parcel of raw land, purchased some years ago for $500,000 but now worth $5 million. The donor could sell the land, and pay $675,000 ($4,500,000 at 15%) of capital gains tax.

For a number of reasons, the donor might also consider forming a CRT, and contributing the land to the CRT prior to sale. The CRT would then sell the land, and the entire amount of capital gain would avoid immediate taxation. But, under the old law, if the CRT later in the same tax year incurred even $1 of UBTI, then the CRT would lose its income tax exemption for that tax year, and the CRT would be liable for any capital gains tax. The amount of capital gain subject to tax would be reduced by the amount of capital gain actually distributed to the donor. If the CRT were paying the minimum required payout of 5%, this would mean that up to $250,000 of the capital gain (depending on funding date) would be paid out to the donor, reducing the CRT's tax bill by $37,500 (15% of $250,000). *The net tax to the CRT would still be $637,500 under the old law.*

Example 4: Consider the same facts under the new law, and assume further that the CRT incurred $10,000 in UBTI from investments made after the sale of the land. *The entire $10,000 of UBTI would be taxed away, but none of the $4,500,000 capital gain would be subject to current capital gains tax in the CRT, a net savings of $627,500.*

We can see that under the old law it was imperative to avoid funding the CRT with an asset that could potentially produce UBTI, and also imperative to avoid reinvesting proceeds from the sale of the initial funding asset into any other assets that could produce UBTI.

New Opportunities for Funding CRTs with Business Interests / Hedge Funds

The new law also opens opportunities for funding CRTs with interests in family or other operating businesses held in partnership form. Opportunities also exist for funding CRTs with hedge funds and private equity interests.

Assume a CRT in which the funding asset was a partnership interest in an active family business, and that the family business used debt-financing in its operations. As such, the asset would produce UBTI. Even without debt-financing, the fact that the partnership operates a business unrelated to the exempt purpose of the CRT, the "pass-through" earnings from the partnership would be considered UBTI to the CRT. Under the old law, if that asset were used to fund the CRT and the asset was held by the CRT for even a short time between funding and sale, it is likely that UBTI would be allocated to the CRT, causing it to lose its exemption from income tax for the entire year. Again, this would cause the entire amount of capital gain (less amounts distributed to the donor as part of the donor's retained interest) to be subject to tax—a potentially disastrous result.

Again, the new law provides significant relief in that only the fairly small amount of UBTI allocated to the CRT between funding and sale would be subject to current tax in the CRT.

In sum, for the initial funding year the new law provides significant relief by exposing only the UBTI, not the entire income of the CRT, to current taxation.

Income Tax Implications of Investments After Initial Funding

Should the change in the law give us reason to reexamine the composition of assets within an existing CRT?

Just a few years ago, a glimpse into most trusts would have revealed little more than plain-vanilla domestic stocks and bonds. While many trusts are still limited to these traditional asset classes, new trends are emerging. Wealth-structuring experts are thinking more holistically than ever before. They are, for the first time, combining state-of-the-art planning techniques with the most sophisticated investment strategies, and utilizing the full spectrum of alternative investments—including private equity (venture capital, buyouts, distressed debt), private real estate, hedge funds, and capital markets strategies.

Alternative Investments: Hedge Funds and Private Equity (Potential UBTI-Producing Investments)

As noted above, UBTI-generating investments will no longer jeopardize a CRT's tax-exempt status. Instead, an excise tax will be imposed equal to the UBTI in that particular year; that is, $1 of UBTI equals $1 of excise tax, which must be paid out of principal. The income so generated *may* also be distributed to the beneficiary, who will be taxed on it at the beneficiary's income tax rates, as high as 35%, if ordinary income or short-term capital gain; or 15% if long-term capital gain. If incurred, UBTI effectively creates a double tax, once at the trust level, and next at the beneficiary level. The CRT must complete Form 990-T in years it encounters UBTI.

CRT Investments with Income Derived Substantially From UBTI

An investment that generates all of its income in the form of UBTI should be avoided at all costs. The excise tax being 100% of the UBTI would result in no net earnings for the CRT. In essence, the investment is made on behalf of the government, as all its UBTI is turned over to the government in the form of excise taxes. Adding insult to injury, the beneficiary may also be taxable on the UBTI since it finds it way into the four-tiered payout system.

CRT Investments with a Portion of Income Derived From UBTI

Other investments, such as certain hedge funds and private equity investments may provide appropriate investment diversification while producing only a small percentage of its income as UBTI. While a thorough analysis of the potential implications of each investment should always be undertaken, hedge funds may now be an appropriate investment for CRTs.

For instance, a hedge fund that produces $100,000 of investment returns may result in only $10,000 of income attributable to UBTI. In this author's experience, there are some hedge funds that generate very small amounts of UBTI, as compared to their overall return. Even so, it is difficult to forecast the amount of UBTI, if any, from year to year. The actual amount of UBTI will be a function of the fund's underlying investments and its use of leverage in pursuing its investment strategies. Nonetheless, most people think of an investment as either producing all or none of its income in the form of UBTI. The following is more likely the case:

Assume a CRT with a value of $5 million is invested in a broadly diversified group of assets, including 30% in hedge funds and private equity investments. Also assume that the hedge funds and private equity generate $150,000 in short-term capital gains, of which $15,000 is attributable to UBTI (because of debt-

financed activities within the hedge funds). As a result of the UBTI, the CRT will be hit with a $15,000 tax, payable from principal. The $15,000 will also be added to the appropriate tier under the trust's four-tier income tax accounting

Of course, the previous illustration and the opportunities created by the change in the law beg the question: Do so-called alternative investments add enough gains to justify the friction created by the UBTI penalties? How should a CRT be invested after initial funding? If the investment returns are significantly enhanced by allocating a portion of the portfolio to investments that produce a small amount of their returns as UBTI, the UBTI-tax may be outweighed by the long-term investment performance. Conversely, if the investment risk is significantly decreased by diversifying the portfolio to include investments that produce a small portion of their returns as UBTI, the UBTI tax again may be outweighed by the long-term results of a well-diversified portfolio.

Investing in alternative investments is not new to CRTs. Even prior to the change in law, CRTs could gain exposure to such investments through the use of sophisticated planning, such as utilizing offshore hedge funds that block the receipt of UBTI. However, the use of this technique often raised complicated tax issues because many of the offshore hedge funds are characterized as passive foreign investment companies (PFICs) for US tax purposes. A PFIC is a foreign corporation with substantial passive income or such an entity owning a substantial amount of assets which are held to produce passive income. Most foreign hedge funds, which are typically owned by foreign investors or US tax-exempt entities, are PFICs. The interaction between the income tax rules governing PFICs and CRTs is complicated and unclear at best and beyond the scope of this article. There is an effort in Congress to change the UBTI rules for certain investment partnerships. The proposed change would allow tax-exempt entities to directly invest in on-shore hedge funds and other investment funds without incurring UBTI.

More recently, CRTs have gained exposure to alternative investments through the use of structured investments designed to mimic the return of university endowments. Indeed, there have been several private letter rulings regarding UBTI in CRTs which have contractual rights to investments tied to the returns of university endowment funds. Presumably, the donors and beneficiaries of CRTs wanted the stellar returns associated with university endowments (which resulted from investment acumen and a healthy exposure to alternative investments) in their CRTs. In order to facilitate such investments, the university's endowment issued units to the CRT based on the value of the CRT's funds "invested" in the endowment. While the CRT did not have a right to the endowment's underlying assets, its unit value was determined based on the return of underlying endowment. After the initial ruling, several other universities followed suit. While this structure was novel and permitted the CRT to gain exposure to alternative asset classes, the IRS did note in the Rulings that the payments attributed to the increase in value of the units would be subject to ordinary income tax, thereby losing the potential for qualified dividend and capital gain preferential treatment.

Conclusion

As a result of the recent changes, trustees and investment managers for CRTs need to rethink portfolio construction alternatives. Previously, the loss of the exemption from federal income tax for CRTs with even $1 of UBTI dictated that no potentially UBTI-producing investments should even be considered for CRTs. However, with the change in law, it may now be appropriate to consider using investments that potentially cause UBTI, if their risk mitigation and return characteristics are such that they outweigh the cost of the new excise tax and enhance the overall portfolio.

Endnote

1. The funding order of distributions to the beneficiary is a tax-inefficient, four-tiered approach. Distributions must first be made with monies taxed as ordinary income, then current and accumulated capital gains, then tax-exempt income, and finally, as a tax-free return of capital. This distribution system, set forth in IRC Section 664, and referred to as a *worst in-first out* (WIFO) distribution structure, is as follows: (1) Ordinary income (ordinary dividends and/or interest); (2) Capital gains (short-term gains are distributed prior to long-term gains; in current and prior years); (3) Tax-exempt income (in current and prior years); and (4) Corpus/Principal.

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The ABCs of SNTs (Special Needs Trusts)

By Anthony J. Enea

In my practice, and I suspect in many Elder Law practices, the focus is often upon the needs of a chronically ill elderly person and his or her spouse. It has been well documented in recent years that millions of "baby boomers" are "coming of age" and that their aging will have a significant impact upon our medical and long-term-care infrastructure. However, one aspect of aging baby boomers that is often overlooked is the impact their aging will have on the care and well-being of any disabled children for whom they act as parents and caregivers.

Unfortunately, it appears that little is being done to educate aging baby boomers as to what steps should be taken to provide for the future care and well-being of their disabled children.

Special Needs Trusts, also known as Supplemental Needs Trusts, play an important role in the planning for a disabled child. They are generally considered the legal centerpiece of a plan for a disabled person.

I. Pre-Drafting Issues and Analysis

When drafting a Supplemental Needs Trust (SNT), knowing that the beneficiary of the trust is disabled is by itself not enough. It is important that the attorney prepare a checklist of questions and factors for assessment. The following is a sample of the type of inquiry that needs to be made:

1. Obtain biographical details as to the beneficiary of the Trust. The age of the beneficiary is an important factor to consider, especially when drafting a Self-Settled SNT.
2. Obtain specific details as to the nature of the disability, and level of incapacity of the beneficiary of the trust. Inquire as to whether the incapacity is physical or mental. Make inquiry as to the medications, if any, the beneficiary is taking. Is the medication psychotropic? How long has the beneficiary been disabled? Is the beneficiary's illness progressive? How long is the disability anticipated to last? Is the illness medically recognized?
3. What are the functional abilities and limitations of the proposed beneficiary? For example, is the beneficiary:
   (a) able to cook, clean and attend to his or her own personal hygiene? Can the beneficiary handle his or her finances and live independently?
   (b) able to participate in decisions?
   (c) employed? Nature of employment? Salary? Is there a history of employment?
   (d) Also, what is the beneficiary's level of education? Has the beneficiary received any special training?
4. Where is the proposed beneficiary presently residing? What type of housing will the beneficiary need in the future (group home, institutional, living with family/renting an apartment)? Is the housing Federally subsidized?
5. What government benefits, if any, is the beneficiary receiving (SSI/SSD/Medicaid Community/Institutional)? How long has the beneficiary received these benefits?
6. What are the anticipated future needs of the beneficiary?
7. Any potential sources of assets? Inheritance, family, siblings? Ask whether the trust beneficiary is presently a named beneficiary or a contingent beneficiary in a Will or Trust.

It is important to explain to the client that the SNT is for non-basic needs; it is not a trust for basic needs, such as food, clothing and shelter. Explain to the client that the purpose of the SNT is to provide for the preservation of funds that are permitted to be made available to a disabled person without affecting his or her eligibility for government benefits such as Medicaid and SSI (Supplemental Security Income). It is also important to explain to the client the federal standard for determining that the beneficiary of the SNT is a "disabled person" as required by statute.

Under Federal law, a disabled person is defined as a person "unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."[1] If one is receiving Medicaid or SSD, he or she is considered "disabled."

II. Three Basic Types of Supplemental Needs Trusts

A. Third-Party SNT

1. A Third-Party SNT is a Trust created and funded by someone other than the disabled beneficiary. It is generally created by a parent, grandparent or sibling. The disabled person does not provide the funds for a Third-Party SNT. Any other individual can fund this

type of trust for a disabled beneficiary without affecting the beneficiary's entitlement to government benefits.

It is important to note that the SNT can be *inter vivos* or testamentary. The spouse of a disabled beneficiary or the parent of a minor disabled beneficiary cannot create and fund an *inter vivos* SNT and secure the protections under EPTL 7-1.12 for government benefits. However, the spouse or parent can fund and create a testamentary trust for the disabled beneficiary.

All too often we tend to think of SNTs as *inter vivos* trusts. However, their use in testamentary documents such as a Will should be given consideration.

In *In re Escher,*[2] ultimately codified at EPTL 7-1.12, the Bronx County Surrogate's Court held that a testamentary trust established by parents of a disabled daughter which provided that the principal was to be used only for the "necessary support and maintenance" of the daughter was protected from the claim of New York State for reimbursement of the amount it had paid on behalf of the daughter. The Court found that the testator had intended that the principal be used for the daughter during her lifetime.

It should also be noted that the funding of a Third-Party SNT has Medicaid planning benefits for the grantor of the trust. The transfer is considered an exempt transfer. Thus no period of ineligibility is created.[3]

B. Self-Settled or First-Party SNT

Self-Settled Trusts are authorized by the Omnibus Budget Reconciliation Act of 1993 (OBRA93). These are SNTs funded with a disabled beneficiary's own funds, or funds to which the beneficiary is entitled, such as a personal injury award or inheritance. In order for the disabled beneficiary to establish and fund a Self-Settled SNT, the beneficiary must establish the following:

(a) Must be disabled (proof of SSI or SSD is generally sufficient);

(b) Must be under the age of 65 (as of the date the assets are transferred to the Trust);

(c) Must be established for the benefit of the disabled beneficiary, by a parent, grandparent, guardian or court. Once established it may be funded by the disabled beneficiary. If the disabled beneficiary has no parent or grandparent, it will be necessary to obtain a court order, pursuant to Article 81 of the Mental Hygiene Law or SCPA 2101 and 202. The transfer of a disabled beneficiary's funds to the Self-Settled SNT creates no look-back period or ineligibility period for Medicaid nursing home benefits, so long as the disabled beneficiary is under the age of 65 at the time the gift to the trust is made.

(d) Must have a payback provision. Upon the death of the disabled beneficiary all remaining trust principal and accumulated income must be paid back to Medicaid to reimburse Medicaid for all benefits paid to the disabled beneficiary during the beneficiary's lifetime. Any funds left over may be paid to the named beneficiary of the trust.

If the disabled beneficiary is competent and has a parent or grandparent willing to be the creator, a court order is not required to create and fund a Self-Settled SNT. If the disabled beneficiary is mentally incapacitated, then regardless of the existence of a parent or grandparent a court order is required for the assets or income of the beneficiary to be transferred to the SNT. If the disabled person is competent and has no parent or grandparent, a court order is required.

Court orders are normally obtained within an Article 81 Guardianship (it can be a single transaction guardianship) or, if the matter involves an inheritance or if funds are received by a developmentally disabled or mentally retarded person, then it is obtained within a 17A proceeding in the Surrogate's Court.

C. Pooled Self-Settled SNT

A Pooled Self-Settled SNT is one that must be managed by a non-profit organization. For example, the United Jewish Appeal and the New York State Association of Retarded Citizens sponsor such Pooled Trusts for disabled persons.

All of the funds transferred are pooled in a single trust, but a separate account is established for each individual beneficiary. The beneficiary can be under or over the age of 65. However, if the beneficiary is over the age of 65 there is a penalty period for assets transferred to the Pooled Trust for Medicaid nursing home benefits. These trusts are usually utilized where there is no family member to act as a trustee or when the beneficiary is over age 65.

Depending on the terms of the Pooled Trust, the disabled person may be able to specify how the remaining balance of his or her account is to be distributed upon his or her death. However, these funds would also be subject to a payback to Medicaid. If the balance on death is retained by the Pooled Trust, then Medicaid is not entitled to a payback of the benefits paid.

Pooled Trusts play an important role when the disabled beneficiary has fixed income that exceeds the monthly amount permitted by the Medicaid home care program. For example, if a Medicaid home care applicant has income in excess of the permitted $700 per month for the year 2007, he or she is allowed to contribute this excess income to a Pooled Trust. The trust will then pay the disabled beneficiary's household expenses, such as mortgage, rent and taxes, which the beneficiary would not be allowed by Medicaid to pay.

The Pooled Trust in many cases allows the beneficiary to remain at home and still be eligible for Medicaid home care.

III. General Drafting Considerations for SNTs

The following are some provisions to consider including in an SNT:

(a) Make specific reference in the instrument to the fact that the trust is intended to comply with *In re Escher*.

(b) Make specific reference in the instrument to the fact that the trust is intended to comply with EPTL 7-1.12.

(c) Provide that the trust corpus is to be used on behalf of the disabled individual to "supplement" and "not supplant" government benefits such as Medicaid and SSI, and that the funds are not to be used for basic needs such as food, clothing and shelter. However, it is still important to give the trustee the power to make distributions to meet the beneficiary's basic needs (food, clothing and shelter), even if it will diminish or impair the beneficiary's receipt of government benefits. This is commonly referred to as the "Notwithstanding Consequent Effect" provision of an SNT.

Third-Party Trusts should also provide that the trustee has the full and absolute discretion to pay out principal and income. However, the use of an ascertainable standard such as "for health, education, maintenance or support" should be avoided.

IV. Drafting Considerations for Court Approval of SNT

When requesting that the court approve an SNT, the Petition to the Court seeking such approval should articulate the following:

(a) Disabled beneficiary's life expectancy and life care plans;

(b) Projected growth of funds;

(c) Estimate of how long the funds will last.

With respect to court-ordered SNTs, different courts have different drafting requirements.[4] In *In re Morales*, the Court offered a model SNT to be used in New York City. The Department of Social Services must be notified when a court-ordered Self-Settled SNT is being requested.

In drafting an SNT, it is important to be familiar with the beneficiary's specific disability. For example, the needs of a competent physically disabled non-elderly beneficiary will be different than those of someone who is mentally incapacitated and physically disabled. The competent physically disabled beneficiary can be actively involved in the decisions concerning the drafting and implementation of a Self-Settled SNT and the beneficiary's future care plan. For example, the beneficiary can be made a member of an advisory committee to the trustees.

It is also important to know what government benefits programs will support the beneficiary. Will it be institutional or non-institutional? This will provide the attorney draftsman with an idea of how trust assets can be used and the specific terms to be contained in the trust, as well as how to prepare an additional memo to the trustees about their use.

For example, a severely developmentally disabled individual residing in a group home may have more predictable needs than an individual suffering from a psychiatric illness who resides in Federally subsidized housing and is receiving outpatient mental health services. The latter individual will most likely be receiving SSI, and any distributions for food or shelter by the trustee of the SNT will affect the SSI coverage.

On the other hand, an individual in a group home may be receiving basic community Medicaid without SSI, so the trustee may be free to use trust funds to support a reasonable housing arrangement and provide other necessities that will enhance the beneficiary's ability to reside in the community.

It is important to consider the functional level of the beneficiary, that is, the beneficiary's ability in an advisory capacity to participate in decisions regarding trust expenditures and management.

V. Sole Benefits Trust

Finally, it should be noted that a new special type of SNT has been gaining increased popularity. A Sole Benefits Trust ("SBT") is a special type of Third-Party Trust. It is not counted as an available resource to the trust beneficiary for purposes of determining the beneficiary's Medicaid and SSI eligibility so long as it is set up as a Third-Party SNT. The third party funding an SBT may do so without incurring a transfer penalty for purposes of his or her own eligibility for Medicaid and SSI.

An SBT is often used when a plaintiff who settles a claim or suit wants to set aside funds from the settlement to provide for a disabled friend, child or grandchild, while still preserving his or her own eligibility for Medicaid or SSI.

An SBT must meet all of the Third-Party SNT requirements. It must provide that the beneficiary is the only person who will benefit from the funds in the trust, presently and at any time in the future. The trust must also provide that the assets in the trust will be spent or distributed in a manner that is "actuarially sound." Assets are to be distributed each year in an

amount that is calculated to deplete the trust within the beneficiary's remaining life expectancy.

A Sole Benefits Trust does not have to meet the "actuarially sound" requirement if it is an exempt SNT or Pooled Trust under OBRA93 and the Foster Care Independence Act of 1999 (FICA). However, it would then lose its primary advantage over an OBRA93 and FICA exempt trust in that it does not need to be created by a court, parent, grandparent or legal guardian of the beneficiary, and is not required to contain a state payback provision. It is recommended that an SBT be actuarially sound in order to maintain its flexibility. It need only provide that a minimum amount be paid to the beneficiary that will deplete the trust over the beneficiary's life expectancy.

An SBT can be funded with a lump sum or an annuity. However, it must be fully funded before the beneficiary reaches the age of 21. It is administered in the same manner as a Third-Party SNT to preserve the beneficiary's eligibility for Medicaid or SSI. Any third party can transfer funds to a Sole Benefits Trust.

Where the beneficiary's ability to qualify for Medicaid or SSI is not a concern, the SBT can be administered to provide for the beneficiary's general health, education, welfare, support, maintenance and comfort, so long as the trust is created for the grantor's blind, disabled or minor child, or for any other disabled individual under age 65, and the trust meets the SBT requirements. The grantor's transfer of assets to fund the trust will not subject the grantor to a Medicaid transfer penalty.

Where there is a concern about Medicaid or SSI eligibility, neither the plaintiff, the beneficiary, nor the spouse of the plaintiff or beneficiary may act as a trustee. Otherwise, the assets in the trust would be considered an available resource, and adversely affect Medicaid and SSI eligibility. If the beneficiary's eligibility for Medicaid and SSI is not an issue, the beneficiary or the beneficiary's spouse could act as trustee.

VI. Effect of Medicaid Lien on Funding of an SNT

The U.S. Supreme Court's decision in *Arkansas HHS v. Ahlborn*[5] had a dramatic impact on the law governing Medicaid liens and the funding of SNTs.

Under *Ahlborn*, when a Medicaid recipient receives a personal injury settlement following the payment by Medicaid of medical costs, the Medicaid lien amount is limited to the amount of proceeds meant to compensate the recipient for medical costs, and not for damages for pain and suffering, lost wages and loss of future earnings. This rule also applies to a personal injury settlement or award to a minor.

In *Ahlborn*, there was an agreement apportioning the settlement between medical costs and other damages, but the Court held the result would be the same for a judicially allocated settlement or a jury award, which establishes liability for both medical care and other kinds of damage.

Prior to *Ahlborn*, the rule in New York was that a valid Medicaid lien may be enforced against the entire amount of a personal injury settlement, award or verdict before the proceeds are transferred into an SNT.[6]

VII. Conclusion

The use of a properly drafted Special Needs Trust will help give the parents of a non-elderly disabled child a level of comfort in knowing that they have taken a significant step in assuring the future care and well-being of their child. It is truly the cornerstone of any planning for a disabled person.

Endnotes

1. 42 U.S.C. 1382C(a)(3).
2. 94 Misc. 2d 952, *aff'd* 75 A.D.2d 531, 426 N.Y.S.2d 1008.
3. *See* 42 U.S.C. 1382c(a)(3).
4. *See In re DiGennaro*, 202 A.D.2d 259 (2d Dep't 1994); *In re Goldblatt*, 162 A.D.2d 888; and *In re Morales*, N.Y.L.J. Jul. 28, 1995 (Supreme Ct., Kings Co.).
5. 547 U.S. 268, 126 S. Court 1752 (2006).
6. *Cricchio v. Pennisi* and *Link v. Town of Smithtown*, 90 N.Y.2d 296, 683 N.E.2d 301.

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Israel: Reporting Regulations under the New Law for the Taxation of Trusts in Israel

By Alon Kaplan and Shai Dover

Introduction

In 2008 Israel will celebrate its sixtieth anniversary. Since independence in 1948, Israel has created its own legislation, integrating it where appropriate with the older laws of English common law, traditional Jewish law and the occasional vestige of Ottoman law. Although significant remnants of English common law are extant in important fields, Israel can today be properly said to have adopted its own modern, independent, legal system.

The Israeli legislature has passed many new laws, particularly in the area of civil law, known as a codification. Most of these laws, while independent acts of the Knesset (the Israeli parliament), have roots in western legal systems. For instance, most of the body of commercial law, as well as the laws relating to contracts and to real property, are based on European legal systems.

Concurrently, one may find in modern Israeli legislation institutions from the modern Anglo American world, such as the recent additions to the Companies Ordinance dealing with liability of directors and protection of investors in public companies. Other laws reflect modern economic and legal concepts that evolved out of the European Union and its institutions, such as the Value Added Tax Law.

Israel's tax legislation includes the Income Tax Ordinance (the basic tax law). Until 2003, the Income Tax Ordinance stipulated that income was subject to tax if it accrued in, was derived from, or was received in Israel—territorial taxation. In 2003 the law changed from territorial to worldwide income.

Because of its common law heritage, Israel has always recognized the concept of the trust. The Law of Trust, as its name suggests, introduced and regulated various forms of trusts resembling the Anglo American model, although the general applicability of this law is much wider. Israeli law defines a trust as the duty imposed on one party to hold or otherwise deal with assets under his control for the benefit of another party or for some other purpose.

A trust has no necessary form, and no particular procedure is necessary to form a trust that falls within the law. A trust may cover any situation in which someone has the power to deal with property, not for his or her own benefit, but for the benefit of someone else.

It should be noted that between 2003 and 2006 there was doubt regarding the taxation of trusts in Israel and thus a special Trusts Committee was appointed by the government. As a result of the Committee's recommendations, the tax law was changed to include trusts. The Taxation of Trusts Law that went into force on 1 January 2006 is designed, among other things, to prevent evasion of taxes by residents of Israel through tax planning based on trusts. In order to achieve this goal, an important part of the legislation is devoted to the reporting requirements of the different components of a trust—settlor, trustee and beneficiary.

Types of Trusts in Israel

The new trusts taxation law presents four types of trusts:

- A trust of residents of Israel: A trust in which the settlor is an Israeli resident and at least one beneficiary is an Israeli resident;
- A foreign beneficiary trust: A trust in which the settlor is an Israeli resident and in which there is no beneficiary who is an Israeli resident;
- A foreign settlor trust: A trust created by a foreign resident;
- A trust by will: A trust by virtue of a will of a resident of Israel. This type of trust will be classified for reporting purposes as a trust of residents of Israel or as a foreign beneficiary trust.

While the first two types of trusts represent an attempt by the Israeli Tax Authority to regulate the taxation of trusts that were established by residents of Israel and to prevent tax evasion, the third type, a foreign settlor trust, represents an attempt to create in Israel the conditions that will attract foreign residents to use Israel as a base for their activities. Unfortunately, phrasing problems in the legislation make obscure a number of reporting requirements that are imposed on such trusts. This obscurity can at present only be solved through discussions with the Tax Authority, which is currently working on regulations and directives that will clarify its position.

The Reporting Requirements

Settlor

In all types of trusts the settlor is required to submit an annual report in the year in which he or she created the trust and in every year in which he or she granted a trustee an asset or an income. The law is articulate in a manner that also imposes this requirement on a foreign settlor. The Tax Authority is expected to

clarify its position on this subject in a coming directive. In this report the settlor must identify the trustee, the protector and the beneficiaries, as well as their state(s) of residency. An Israeli settlor who creates a "foreign beneficiary trust" must submit a declaration in the year of creation in which he or she declares that there is no Israeli resident among the beneficiaries. As well, no such beneficiary can be added in the future.

Trustee

A trustee will be required to submit an annual report in Israel in the following cases:

1. A trustee of a trust of residents of Israel is required without exception to submit an annual report.
2. A trustee of a foreign resident beneficiary trust is entitled to receive some reporting relief if he or she has no income and assets in Israel but is obligated to submit a special declaration each year. In the declaration he or she will declare that the trust fulfills the conditions for its existence as a foreign beneficiary trust. Should the person fail to submit the declaration, the trust will be considered as taxable in Israel, and other sanctions will be imposed.
3. A trustee of a foreign settlor trust is required to report only in a case in which during the tax year the trust had an income in Israel or an asset in Israel. The tax authority has not yet formally clarified whether it will consider interest from an Israeli bank account as income, or an account in an Israeli bank as an asset, for the purpose of imposing a requirement for reporting.

The reporting requirements imposed on a trustee completely ignore the question of the residency of the trustee himself. The requirements are imposed in the same manner on a trustee who is a resident of Israel and on a trustee who is a foreign resident. The residencies that are relevant to the reporting requirements are the residency of the settlor and the residency of the beneficiary. Since the issue of reporting in Israel is complex (as is the associated bureaucracy), it can be expected that foreign trustees will employ the assistance of local professionals in order to complete their obligations to the Israeli Tax Authority.

In the annual report, the trustee must report the details of the settlor, the details of each one of the beneficiaries, the dates of distributions and the details of the assets that were distributed. At this writing, the form and extent in which the trustee of every trust will be required to report the income and assets of the trust itself have not been clarified.

Beneficiary

A beneficiary in every type of trust is required to submit a report annually if during the tax year he or she received a distribution from the trustee (monetary or a monetary equivalent) which is greater than NIS 100,000 (at this writing approximately $25,000) and regardless of whether the distribution is taxable in Israel or not. The law is obscure since it imposes the reporting requirement on every beneficiary in the world. The Tax Authority will probably clarify its position on this subject in a forthcoming directive, as well as in the case of a foreign settlor.

In the submitted report, the beneficiary is required to include details about the distribution received.

Conclusion

Trustees of a trust settled by residents of Israel and trustees of a trust settled by foreign residents with income or assets in Israel are required to file an annual report. This requirement is also obligatory for foreign trustees who act in trusts settled by Israeli settlors. Israeli settlors and Israeli beneficiaries are required to file an annual report if several conditions are met.

There is a desire in Israel to create a financial center for the management of trusts by Israeli trustees. The new law includes a number of innovations for encouraging the development of trust activities in Israel. One of these is that the residence of the trustee has no bearing on the tax liability of the trust and therefore an Israeli trustee can act for a foreign settlor trust without making the trust liable for Israeli tax. We are now waiting for the detailed regulations (secondary legislation) to be published in order to ensure that the reporting regulations and the special new rules for encouraging trustee activities in Israel indeed achieve these goals.

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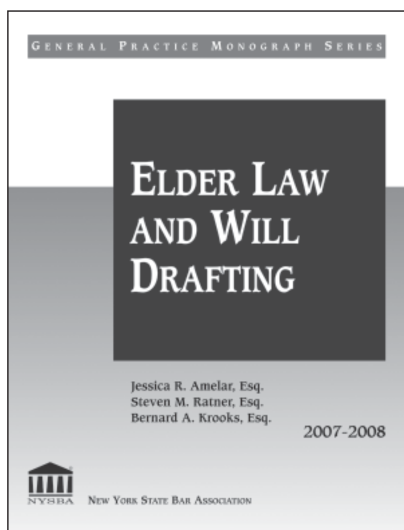

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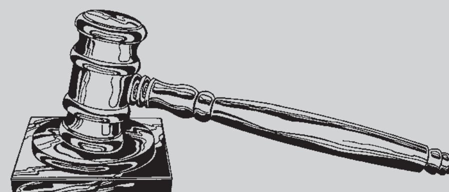
Recent New York State Decisions

By Ira Mark Bloom and William P. LaPiana



FIDUCIARIES

Surety Bond; Cost of Surety Bond May Be Charged Solely Against Share of Distributee Who Did Not Consent to Dispensing with Bond

In two separate administrations, only one of numerous distributees refused to waive the posting of a surety bond by the administrator. The Surrogate held that in both cases the cost of the bond would be assessed only against the share of the non-consenting distributee. Noting that only the non-consenting distributee could benefit from the bond, the court found that it would be fair to charge the cost of the bond only against the share of the person who refused to consent to dispensing with the bond. The Surrogate then concluded that the relevant statutes did not prohibit such an allocation of the expense. Nothing in Article 8 of the SCPA deals with the source of payment of the premium charged for the bond and EPTL 11-1.1(b)(22) merely authorizes the fiduciary to pay the cost of the bond from the property of the estate. The legislative history of the EPTL section only indicates that the payment of estate expenses is subject to the power of the court to make a full and equitable disposition of the matters before it (SCPA 201(3)). The court, therefore, has authority to charge the cost of the bond against the share of the distributee whose interest is protected by the bond. *In re Estate of Dossie*, 16 Misc. 3d 442, 842 N.Y.S.2d 259 (Sur. Ct., New York Co. 2007)

PROCEEDINGS

Discovery; Electronic Discovery by Cloning Hard Drive Allowed to Discover Relevant Deleted Records

In an action to determine the validity of widow's exercise of her right of election, the widow moved for discovery of records of the law firm which prepared the pre-nuptial agreement between the widow and the decedent. In the course of discovery the widow requested access to the business computers of the law firm that represented decedent in the preparation of the pre-nuptial agreement in order to obtain all existing and deleted records pertaining to the agreement and the decedent's estate planning—including billing records, and sample copies of other pre-nuptial agreements prepared by the decedent's attorney—in order to determine his usual course of practice. Unsatisfied with the production by the decedent's lawyer and his firm, the widow moved to have them held in contempt.

The Surrogate denied the widow's request for the billing records relating to estate planning for decedent because they are irrelevant to the validity of the pre-nuptial agreement. Similarly, pre-nuptial agreements prepared for other clients are irrelevant to the question of the validity of the agreement between decedent and widow and are protected by the attorney-client privilege.

Finally, all billing records pertaining to the pre-nuptial agreement and all existing and deleted records pertaining to the agreement are relevant to the instant proceeding, and the court allowed discovery of records on the hard drive of the law firm's computer by a computer forensic expert to be selected by the firm, with the costs to be paid by the widow. The documents extracted from the hard drive are to be submitted in hard copy to the court for determination of any objections raised by the law firm. *In re Maura*, 17 Misc. 3d 237, 842 N.Y.S.2d 851 (Sur. Ct., Nassau Co. 2007)

Jurisdiction; Court Lacked Personal Jurisdiction over Trust

In a proceeding to obtain judicial approval of the executor's accounting of decedent's estate, the Department of Social Services claimed assets in an irrevocable trust based on the decedent's undisputed implied contract to pay DSS for her husband's nursing home care. Although the decedent retained a life estate such that it was a testamentary substitute for elective share purposes, the Appellate Division affirmed the Surrogate Court's decision that personal jurisdiction had not been obtained over the trust. *In re Estate of Tomeck,* A.D.3d, 846 N.Y.S.2d 893 (3d Dep't 2007)

TRUSTS

Diversification; Failure to Diversify Holdings in Closely Held Family Corporation Does Not Violate Prudent Investor Act

Beneficiaries of two testamentary and one lifetime trust objected to accountings by the respective trustees,

alleging that the trustees violated the prudent investor act (EPTL 11-2.3) by failing to diversify trust investments. The Appellate Division affirmed the Surrogate's dismissal of all objections. The concentrated investment was stock in a closely held corporation with an "unusual capital structure" under which the shareholders with voting rights who could make the decision to sell the corporation would not receive the proceeds of a sale which would be paid to holders of a second class of stock. This structure made the corporation especially unmarketable. In addition, the testamentary trustee's decision not to diversify was based on a proper consideration of other factors, including the financial situation of the corporation, the tax consequence of selling very low basis stock, the considerable dividends, and the desire of the creators of the trusts to keep ownership of the corporation in the family through the use of the trusts.

Shortly after the enactment of the prudent investor act, the trustee of the lifetime trust received an offer from the corporation to purchase the trusts shares at "a heavily discounted price." The trustee's decision to reject the offer was reasonable, as was its conduct in regularly exploring the market for the stock as well as its reliance on the corporation's own financial reports. *In re Hyde*, 44 A.D.3d 1195, 845 N.Y.S.2d 833 (3d Dep't 2007)

Successor Trustee; Public Administrator May Act as Successor Trustee of Lifetime Trust

Decedent's will poured over her probate estate of less than $20,000 to a lifetime trust of which the decedent was trustee. None of the persons nominated as executor or as successor trustee was willing to qualify. The Public Administrator filed an application to be appointed successor trustee. The Surrogate granted the application after analyzing the relevant statutes, finding that they do not prohibit the Public Administrator from becoming successor trustee in this situation, and determining that historically the Public Administrator was expressly authorized to administer testate estates. In the absence of any explanation of the omission of testate estates from later versions of the relevant statutes and the need to deal with "orphaned" trusts, the court concluded that the legislature "implicitly contemplated that the Public Administrator may serve as a default trustee." *In re Simmons,* 17 Misc. 3d 161, 844 N.Y.S.2d 598 (Sur. Ct., New York Co. 2007)

WILLS

Due Execution; Proponent Fails to Carry Burden of Proving Due Execution Because of Conflicting Testimony on Publication

The Surrogate denied probate of decedent's alleged will for lack of due execution and the Appellate Division affirmed. The will was drafted by an attorney who testified that testator signed the will in his presence, but declined to complete the execution at that time and indicated that she would procure witnesses herself. When offered for probate the will bore the signatures of three witnesses, but their testimony was confused, and in some instances self-contradictory on whether or not the testator fulfilled the publication requirement of EPTL 3-2.1(a)(3). Although it is sufficient to substantially comply with the requirement, and the existence of an attestation clause in the will raises presumption of due execution, the inconsistencies in the witnesses' testimony was sufficient to support the Surrogate's decision. The court ends its opinion with the suggestion that the best practice "is to discourage clients from executing a will outside the attorney's office, or at the least, without the supervision of an attorney." Otherwise, the testator should be given a detailed written memorandum on the procedures to be followed to insure proper execution of the will. *In re Falk,* A.D.3d, 845 N.Y.S.2d 287 (1st Dep't 2007)

Substitute Executor; Selection of Substitute Executor by Testator's Designee Receives Same Deference as Selection by Testator

Testator nominated his attorney as executor and authorized the attorney to designate his successor. After testator's death, attorney declined to qualify and nominated testator's widow to serve in his place. Testator's child by a previous marriage objected. In what the Surrogate describes as a case of first impression, the court held first that the authority to name a successor encompasses the authority to name a substitute, and that a nomination by person selected by the testator is entitled to the same high level of deference given the selection of an executor directly by the testator. *In re Greenspon,* 17 Misc. 3d 586, 842 N.Y.S.2d 701 (Sur. Ct., New York Co. 2007)

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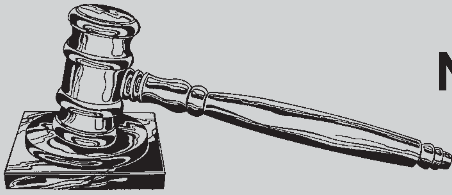
Professors Bloom and LaPiana are the current authors of Bloom and Klipstein, *Drafting New York Wills* (Matthew Bender) (Bloom as principal author; LaPiana as contributing author).



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

By Ilene Sherwyn Cooper

Attorney Disqualification

Defendants moved to disqualify plaintiff's counsel on the grounds of conflict of interest, arguing that plaintiff's counsel had represented one of the defendants in the formation of three joint ventures, and continued, at some level, to represent one of the ventures. Plaintiff's counsel argued that the defendant was a vicarious client and that disqualification was unwarranted inasmuch as the matters in which representation was provided were not "substantially related" to the subject matter of the pending litigation. The court denied the motion.

In reaching this result, the court acknowledged the rule that where an attorney represents a client, the attorney is not per se disqualified from concurrently representing a party adverse to the client, where the client is not directly represented by the attorney but is instead "vicariously" represented through a related entity. In the case of vicarious representation, the standard is the substantial relationship test normally applied to prior representations. Under such circumstances, a party seeking to disqualify an attorney or a law firm on the ground of prior representation must establish (1) the existence of a prior attorney-client relationship, and (2) that the former and current representations are both adverse and substantially related.

Applying the foregoing criteria, the court found that the defendant was not a direct client of plaintiff's counsel, but at most, a vicarious client through its ownership interests in one of the joint ventures. Moreover, the court held defendants had failed to demonstrate that the subject matter of the action was related to the subject matter of the firm's prior representation of the defendant.

Clear Channel Spectacolor Media LLC v. Times Square JV LLC, N.Y.L.J., 10/11/07, p. 26 (Sup. Ct., New York Co.) (Justice Fried).

Disqualification of Fiduciary

In a contested probate proceeding, the issue before the court was the request by the decedent's nephew and sole beneficiary for the disqualification of the nominated fiduciary due to the hostility and friction between him and the fiduciary and her counsel.

After an evidentiary hearing on the matter, the court concluded that disqualification was required. The evidence at the hearing revealed that the decedent's nephew had a long-standing relationship of hostility with the fiduciary's counsel as a result of prior conservatorship proceedings in which counsel was involved in regard to the nephew's late aunt. Counsel opposed the nephew at every turn, failed to communicate with him as to the progress of the matter, and was a detriment to his interests. Further, the record revealed that counsel failed to fulfill their duty to distribute assets to the nephew which rightfully belonged to the estate of his late aunt, despite his status as fiduciary of that estate. The named executor under the decedent's will described his relations with the nephew as "combative."

Based upon the foregoing, the court concluded that to appoint the named executor as fiduciary would subject the estate in pointless and protracted litigation. The court opined that while a testator's choice of fiduciary is to be accorded deference, it cannot be at the expense of the testator's testamentary plan. Under the circumstances, the appointment of the named fiduciary would cause the estate to expend significant sums on legal fees, an expense that the decedent certainly did not intend. Accordingly, given the excessively hostile and bitter relationship between the decedent's nephew on the one hand, and the named fiduciary and her counsel on the other, the court disqualified the named executor from serving in that capacity.

In re Venezia, N.Y.L.J., 11/14/07, p. 27 (Surr. Ct., Kings Co.) (Surr. Torres).

IRA

In a contested accounting proceeding, the decedent's wife and executor of his estate moved for summary judgment dismissing the objections of the decedent's children from a prior marriage to certain distributions from an IRA and investment accounts which named the wife as beneficiary. The objectants maintained that the decedent's execution of a will that created trusts for the lifetime benefit of the wife with the children as remaindermen effectively revoked the beneficiary designations, and therefore, a constructive trust on the assets was required.

The court held that even assuming the objectants were able to establish a confidential relationship and unjust enrichment, the record was absolutely devoid of any proof of a promise, either express or implied, or that the beneficiary designation was made as a result of that promise. Indeed, the court found it significant that the beneficiary designations were made more than four years prior to the execution of the decedent's will.

The court held that the matter was more akin to the situation where a decedent fails to change the beneficiary designation on a life insurance policy or Totten trust account, and the aggrieved parties seek court intervention to do justice. Nevertheless, the court concluded that regardless of the equities, under the circumstances, absent substantial compliance with the requirements for changing a beneficiary designation, the named beneficiary is entitled to the proceeds.

Accordingly, summary judgment was granted in the executor's favor.

In re Boden, N.Y.L.J., 10/26/07, p. 28 (Surr. Ct., Nassau Co.) (Surr. Riordan).

Document Production

In an action for copyright infringement and royalties, the defendant moved, *inter alia,* to compel the plaintiffs to organize and produce over 5,000 date-stamped documents in compliance with federal rules. The federal rules at issue required that documents be produced as they are kept in the normal course of business. The defendant alleged that the plaintiffs "dumped" documents on him without reference to the specific requests to which they related.

The court found that the plaintiffs had complied with federal rules to the extent that the documents they produced were categorized by subject matter. Accordingly, defendant's motion was denied.

In re Eggers, N.Y.L.J., 11/2/07, p. 31 (D.Ct., S.D.N.Y.) (Judge Ellis).

HIPAA

In related decisions, the New York State Court of Appeals was presented with the issue of whether an attorney may interview an adverse party's treating physician when the adverse party has affirmatively placed his or her medical condition in controversy. The court held that the attorney may do so, provided that certain procedural requirements are adhered to.

In *Arons v. Jutkowitz,* the plaintiff-husband and executor of his late wife's estate brought a medical malpractice and wrongful death action against several physicians, other medical professionals, and two hospitals. Once plaintiff filed a note of issue, one of the physician-defendants requested HIPAA-compliant medical authorizations so that his attorneys could interview decedent's treating physician. Plaintiff refused, prompting defendants to seek an order from the Supreme Court directing that the authorizations be provided. The Supreme Court granted the defendants' motion, subject to certain conditions, reasoning that by commencing the medical malpractice action, plaintiff put his late wife's medical condition in issue, thus waiving her physician-patient privilege. The Appellate Division, Second Department reversed, opining that although plaintiff had waived the physician-patient privilege, defendants were only entitled to those discovery devices authorized by the CPLR and the Uniform Rules for the New York State Trial Courts, which do not mention *ex parte* interviews, or mandate that plaintiffs execute authorizations authorizing them.

Further, the court noted that while it had previously held that a treating physician's testimony obtained as a result of an *ex parte* interview could not be precluded at trial, HIPAA created a practical dilemma for defense counsel seeking to conduct such interviews inasmuch as physicians required HIPAA authorizations or a court order before doing so. Finally, the court held that because the note of issue had been filed before the HIPAA regulations became effective, and that requests for discovery after the filing of a note of issue required a showing of unusual or unanticipated circumstances, it modified the Supreme Court order by denying defendants' motion with leave to renew. The Appellate Division subsequently granted defendants' motion for leave to appeal, asking whether its opinion and order were properly made.

In *Webb v. New York Methodist Hospital,* plaintiff brought a medical malpractice action, and, as in *Arons,* after the filing of a note of issue, defendants sought HIPAA-compliant authorizations for *ex parte* interviews with the plaintiff's treating physicians. When plaintiff refused to provide the authorizations, defendants moved in Supreme Court for an order compelling her to do so. The Supreme Court granted the application, and an appeal was taken to the Appellate Division, Second Department. The Appellate Division reversed, based upon its holding in *Arons.*

The opinion in *Kish v. Graham* was of similar import. There, plaintiff-administrator of his late wife's estate brought a medical malpractice suit, and after discovery was completed, defendants sought HIPAA-compliant authorizations to interview decedent's treating physicians. When plaintiff refused to provide the authorizations, the Supreme Court issued an order directing compliance, subject to certain conditions. Thereafter, the Appellate Division, Fourth Department, reversed, on the basis of *Arons,* and thereafter, granted defendants' motion for leave to appeal.

In addressing the issue presented, the court first noted the importance of informal practices in litiga-

tion, particularly private interviews of fact witnesses. Recognizing that it had authorized such interviews within the context of corporate litigation, the court opined that it could see no reason why a nonparty treating physician should be less available for an off-the-record interview than a corporate employee, especially where the physician-patient privilege was waived.

Moreover, the Court noted that while CPLR Article 31 and the Uniform Rules do not expressly authorize informal interviews of treating physicians, they do not preclude such interviews. Nevertheless, in order to allay any dangers of overreaching in the interviewing process, the court cautioned attorneys who approach a nonparty treating physician or other health professional to reveal the client's identity and interest, and make clear that any discussion with counsel is entirely voluntary and limited in scope to the particular medical condition at issue in the litigation.

Indeed, the court noted that it is the common practice of trial attorneys in New York to interview an adverse party's treating physician *ex parte*, particularly in malpractice actions, although only after a note of issue is filed. However, the court acknowledged that such practice and its underlying precedent had to be reconciled with the regulations and restrictions of HIPAA.

In considering the impact of HIPAA on *ex parte* interviews, the court noted that while HIPAA permits uses and disclosures of health information, the "covered entity" is not required to act on an authorization it receives, even if valid. Similarly, the court noted while HIPAA permits covered entities to use or disclose protected health information without authorization pursuant to a court or administrative order, or in response to a subpoena, discovery request or other lawful process, if the entity has received satisfactory assurances that the individual has been provided notice of the request, or has made reasonable efforts to secure a qualified protective order from a court or administrative tribunal, compliance by the health care professional cannot be mandated.

On the other hand, the court recognized that the litigation exception to HIPAA was not intended to undermine current practice which precludes an individual who is a party to a proceeding and who puts his or her medical condition in issue from prevailing if he or she does not consent to the production of his or her health information. Moreover, the court noted that while HIPAA will preempt state law, absent a specific exception, to the extent that it is in conflict with the Regulations, that there could be no conflict between New York law and HIPAA on the subject of *ex parte* interviews of treating physicians because HIPAA does not address the subject.

Accordingly, on the basis of the foregoing, the court found that HIPAA did not prevent the informal discovery at issue from going forward, but merely superimposed procedural prerequisites on the discovery process; to wit, a requirement that the attorney first obtain a valid HIPAA authorization or a court or administrative order; or, issue a subpoena, discovery request or other lawful process with satisfactory assurances relating to either notification or a qualified protective order. The court therefore held that the defendants involved in the subject appeals had properly proceeded to obtain an interview of the plaintiffs' treating physicians. The court found that the plaintiffs had waived the physician-patient privilege, and therefore there was no basis for their refusal to provide the authorizations and information sought. Again, however, the court reminded counsel that, despite an authorization or a HIPAA court order, the treating physicians were free to decide whether or not to cooperate with defense counsel.

Moreover, the court held that it was improper for the trial courts in *Arons* and *Webb* to have directed that defense counsel provide their adversaries with all written statements and notations obtained from the physician during the private interviews, as well as any audio or video recordings or transcripts and interview memoranda or notes, inasmuch as these limitations were not required by HIPAA and inconsistent with judicial precedent.

The orders of the Appellate Division were therefore reversed, with costs, and the defendants' motions to compel plaintiffs to provide the subject authorizations granted in accordance with the parameters of the opinion.

Arons v. Jutkowitz, 2007 N.Y. Slip Op. 09309, decided November 27, 2007.

Statute of Limitations

Before the court was a contested discovery proceeding, in which the petitioner alleged that the respondent, her brother and only other distributee of the estate, held assets including bank accounts, life insurance proceeds and the contents of a safe-deposit box, which he fraudulently conveyed to himself prior to the decedent's death and which belonged to the estate. The petitioner requested that an inquiry be held of the respondent. The respondent answered the petition in which he denied the allegations and interposed the statute of limitations as a defense. Thereafter the respondent moved to dismiss the petition on the grounds, *inter alia,* that it was time-barred.

The court opined that discovery proceedings pursuant to SCPA 2103 are subject to a three-year statute of limitations applicable to replevin and conversion actions. However, when fraud is alleged, the applicable statute of limitations is either six years from the com-

mission of the wrong, or two years from the discovery of the fraud, or the date upon which the fraud could have reasonably been discovered, whichever is later. On a motion to dismiss a petition, the question to be determined is whether the petition, liberally construed and accepted as true, states a cause of action not otherwise time-barred. A dismissal will only be warranted where the facts alleged fail to fit within any cognizable legal theory.

Based upon the foregoing, the court found that the petition, supported by the documents submitted to the court in opposition to the motion, related a set of facts by which the respondent may have perpetrated a fraud upon both the deceased and the petitioner, resulting in the delay in the commencement of the discovery proceeding. The court opined that where the question is when the fraud could have or should have been discovered, and there is a factual dispute as to when the party alleging fraud knew or should have discovered the alleged fraud, the action should not be dismissed without an evidentiary hearing.

Accordingly, the motion was denied.

In re Balsamo, N.Y.L.J., 9/10/07, p. 29 (Surr. Ct., Richmond Co.) (Surr. Fusco).

Summary Judgment

In a contested probate proceeding, the proponent moved for summary judgment dismissing the objections filed by the decedent's nephews.

Extensive pre-trial discovery revealed that the decedent was introduced to the draftsman by the proponent of the will. The draftsman prepared and supervised the execution of the propounded will and the penultimate will. The draftsman testified that the proponent was his "client contact" and that he had not communicated with the decedent directly regarding the will provisions. Significantly, while the draftsman testified that the proponent was present when the will of the 98-year-old testatrix was executed, the proponent testified he was not.

The draftsman further testified that after the penultimate will was executed, he and the proponent revisited the instrument with the decedent, and began to discuss a new instrument with her that would alter her testamentary plan in favor of the proponent, his mother and aunt. The draftsman stated he was concerned that he could be liable for malpractice in drafting the penultimate will, which left the decedent's sizable estate to her 88-year-old sister, and thus he suggested that the decedent change her estate plan. Although the decedent initially rejected the idea of redoing her will, the propounded will was ultimately drafted a little over three months after discussions began, and was executed by the decedent when she was in the hospital for a heart condition. The instrument increased the legacy to the proponent from $500,000 to $1.2 million. Several of the proponent's friends, who were attorneys, were present. These people were strangers to the decedent. The court found the testimony regarding execution unclear, most particularly as to whether the draftsman explained the provisions of the new will to the decedent.

The proponent and the objectants submitted affidavits in support of and against the motion for summary judgment. Evidence was conflicting as to the decedent's mental status and interactions with the family. The objectants' witnesses described the decedent as phobic and disoriented as to time, place and person. This was in part confirmed by the testimony of the draftsman, who, as a result of a conversation with the decedent, was under the misconception that the decedent had a daughter, when in fact she had no children.

Based upon the foregoing, the court denied the proponent's motion. On the issues of due execution and testamentary capacity, the court held that, despite the fact that the execution of the propounded will was supervised by an attorney, a question of fact existed as to whether the decedent knew the natural objects of her bounty, was aware that she was executing a will, and was made aware of the provisions of the instrument prior to its execution. The court held that the situation was especially questionable given the decedent's age, the fact that she executed the propounded will while lying in a hospital bed, and that she had no relationship with the draftsman.

With regard to the issue of undue influence, the court expressed concern over the fact that the draftsman apparently provoked the decedent to change her will, and that the proponent was the draftsman's "client contact." Thus, the court held that it was unclear whether the terms of the instrument were actually made known to the decedent and reflected her wishes.

Finally, on the issue of fraud, the court concluded that a question of fact existed as to whether the draftsman's concerns with his potential liability for malpractice was a pretext for his convincing the decedent to disinherit the primary beneficiary under the penultimate will in favor of the proponent.

In re Estate of Barofsky, N.Y.L.J., 11/20/07, p. 34 (Surr. Ct., New York Co.) (Surr. Roth).

Testamentary Capacity

In a contested probate proceeding, the objectants moved for an order dismissing the probate petition, or in the alternative for partial summary judgment finding that the decedent lacked testamentary capacity when she executed the propounded will. The petitioner cross-moved for summary judgment dismissing the objections and granting probate.

The record revealed that two years prior to the execution of the propounded instrument, dated May 9, 1997, the decedent had a stroke, which caused her to suffer from sensory and expressive aphasia and memory changes. Shortly after she executed her will, the decedent's husband passed away. Because the decedent could not care for herself, a petition was filed by the person ultimately named as the executor in the propounded instrument requesting her appointment as guardian of the person and property of the decedent. The matter was contested and set down for a hearing. Following the hearing, the court rendered an order and decision, dated September 29, 1997, in which it found that the decedent had organic brain syndrome and dementia and was in need of a guardian. The court appointed the petitioner and one of the decedent's maternal cousins as guardians of her person and property and directed that she be placed in a medically assisted supervised home.

Several years thereafter, the decedent died, and a petition was filed for probate of her will. Two of the decedent's maternal cousins, one of whom was her co-guardian during life, filed objections alleging lack of testamentary capacity, fraud and undue influence. Upon the completion of discovery, the objectants moved to dismiss the probate petition on the grounds, *inter alia*, that the petitioner was judicially estopped from denying that the decedent lacked testamentary capacity when the will was executed. In the alternative, objectants moved for summary judgment on the grounds that the record before the court established the decedent lacked testamentary capacity.

The court denied the objectants' motions. On the issue of judicial estoppel, the court held that the theory of estoppel precludes a party from adopting a position directly contrary to or inconsistent with a position he or she assumed in a prior proceeding, whether in a deposition, prior pleading or testimony before the court. The court noted that the doctrine is applied in the exercise of the court's discretion based upon a variety of factors, including whether the inconsistency of positions is clear and unambiguous, and whether the court relied upon the position in the first proceeding in reaching its result.

Applying these criteria to the case, the court held the petitioner's assertion that the decedent needed a guardian was not inconsistent with the assertion that she possessed testamentary capacity at the time she executed her will. The court found that testamentary capacity and incapacity under the Mental Hygiene Law were distinct, and that less mental capacity was required to execute a will than any other legal instrument. As such, the will of an incompetent may be admitted to probate if executed at a time when the decedent's mind was sufficiently clear so as to possess the requisite elements of testamentary capacity. The court therefore found the petitioner's claim that the decedent needed a guardian was not predicated upon a position that she lacked testamentary capacity, and that the determination by the court that a guardian was needed for the decedent was not based upon any such finding.

Further, the court held that the record, including the allegations and testimony in the guardianship proceeding, and the medical records of the decedent, raised a question of fact as to whether the decedent possessed testamentary capacity on the date the propounded will was executed, and thus was a matter to be determined at trial.

In re Estate of Gallagher, N.Y.L.J., 10/29/07, p. 19 (Surr. Ct., Kings Co.) (Surr. Torres).

Validity of Trust

Before the court was a proceeding to invalidate an *inter vivos* trust on the grounds, *inter alia,* that it was drafted and executed in order to induce the divorce between the grantor and his wife, and was thus void as against public policy. The respondents-trustees moved to dismiss these causes of action alleging that they failed to state a cause of action.

The court stated that conditions attached to a gift in trust tending to induce a husband and wife to divorce are void on public policy grounds provided that the trust terms demonstrate a manifest intent to induce the beneficiary, in his mind, to obtain a divorce, and where the means employed are calculated to promote it.

Upon review of the provisions of the subject trust, the court found that none of the terms conditioned the disposition of the assets upon the grantor obtaining a divorce. The court opined that while the administration of the trust by the respondents, and more significantly, the exercise of their discretion, may have been directed to promote or encourage a divorce between the grantor and his wife, this circumstance was not sufficient to declare the trust void *ab initio.*

Accordingly, the respondents' motion was granted and the causes of action dismissed.

In re Krusos, N.Y.L.J., 10/9/07, p. 47 (Surr. Ct., Suffolk Co.) (Surr. Czygier).

Ilene Sherwyn Cooper, Partner, Farrell Fritz, P.C., Uniondale, New York.

Fourth Annual International Estate Planning Institute

11.0 MCLE Credits

Co-sponsored by the Trusts and Estates Law Section, the International Law and Practice Section, the Committee on Continuing Legal Education of the New York State Bar Association, and by the Society of Trust & Estate Practitioners (STEP)

Tuesday and Wednesday, May 27 and 28, 2008

New York Marriott Marquis

Program Overview

Tuesday, May 27

- Introduction: ***G. Warren Whitaker***
- Introduction to International Estate Planning: ***Michael A. Heimos***
- Reporting International Trust and Gift Transactions and Penalties for Failure to Report: ***Evelyn M. Capassakis***
- International Divorce Proceedings: ***Dawn Goodman***
- US Immigration Law – How to Get or Lose US Citizenship or Residence: ***Steve Trow***
- FATF, International Money Laundering Initiatives and the Lawyer's Ethical Dilemma: ***Gideon Rothschild***

5:30 - 7:30 p.m. Cocktail Reception

Wednesday, May 28

- Introduction: ***G. Warren Whitaker***
- UPDATE – Canada (Third and Fifth Protocols): ***Geoffrey Dyer***
  QUESTIONS
- UPDATE – Mexico - Offshore Planning Ideas for Mexicans: ***Claudia Cafuzzi***
  QUESTIONS
- UPDATE – United Kingdom (Latest Developments): ***Mark Summers***
  QUESTIONS
- UPDATE – France (Treaty with U.S. and Taxation of Trusts): ***Jean-Marc Tirard***
  QUESTIONS
- LUNCHEON SPEAKER: Michael Pfeiffer, Caplin & Drysdale, Washington D.C. "Expatriation—An Informal History" (There is no MCLE credit for this segment)
- PFICS and CFCS - Recent Developments: ***Donald D. Kozusko***
- "Just Pay It To My Brother" – The Intermediary and "Give and Go" Rules: ***Dina Kapur Sanna***
- Purchase of U.S. Residences by Foreigners: ***Stanley Ruchelman***
- "The Tax Haven Abuse Act" and recent U.S. legislation: ***Steven Cantor***

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