Tax News & Comment

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IRS & NYS DTF Matters

Recent Developments & 2023 Regs. & Rulings of Note

NY Estate Tax Planning

I. NYS Estate Tax Planning in 2024

The unusual manner in which the estate tax in New York operates is a trap for the unwary and requires a degree of attention unusual even for tax statutes. It is not that the statute is complex, although it is that. Rather, it is the fact that once the threshold exemption is reached — below which there is no estate tax — every quantum of increase in the taxable estate above the threshold exemption amount is taxed in short bursts at astronomical rates nearing 200 percent until the size of the taxable estate exhausts the exemption a short time later, at which

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From Federal Courts NYS Courts & Tax Tribunals

Supreme Court to Hear "Existential" Case Challenging Constitutionality of Tax Premised on Lack of Realization

Implications for Biden's Capital Gains Proposal

Pending Tax Case Alert

I. Supreme Court

On December 5, the Supreme Court will hear oral arguments in *Moore v. United States*, on appeal from the Ninth Circuit on writ of certiorari. In upholding the contested tax statute, the Ninth Circuit dismissed the taxpayer's refund claim, holding that realization of income is not a constitutional requirement, but rather "one of administrative convenience."

The case is at once troubling and compelling, since as the Ninth Circuit observed, a different holding "would call into question the constitutionality of many other tax provi-

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From Washington & Albany

Presidents Biden and Trump Offer Sharply Contrasting Tax Visions

Extend Tax Cuts or Let Them Expire on 12/31/2025?

Tax News & Analysis

I. Introduction

President Trump's 2017 Tax Act is set to expire December 31, 2025. Individual income tax rates will revert to 2017 levels, the standard deduction will be cut in half, the personal exemption will return, the estate tax exemption will revert to \$5.3 million, the 20% deduction available for pass-through business entities will expire, and the cap on state and local income tax (SALT) will end. The provision reducing the corporate tax rate to 21% was made permanent and will not expire.

Accordingly, significant federal tax law changes will occur simply by reason of the "sunset" of the 2017 Act

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Fiduciary Income Taxation of Nongrantor Trusts: An Overview

Fiduciary Income Tax

I. Introduction

Nongrantor trusts are taxable entities which must file income tax returns and issue Schedule K-1 to beneficiaries. For the taxable year 2023, a tax rate of 37 percent is imposed on undistributed trust income over \$14,450. Nongrantor trusts arise where the grantor has parted with sufficient dominion and control such that the federal income tax no longer applies to the grantor, but rather to the trust.

Taxable income of a trust is computed much like that for individu-

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The Decedent's Last Will: A Final Profound Statement

Estate Planning

I. Introduction

A will is a written declaration providing for the transfer of property at death. Although having legal significance during life, the will is without legal force until it "speaks" at death. Upon the death of the decedent, rights of named beneficiaries vest, and some obligations of named fiduciaries arise. However, the will cannot operate to dispose of estate assets until it has been formally admitted to probate. Historically a "will" referred to the disposition of real property, while a "testament" to referred to a disposi-

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December Comment

Special Needs Trusts For Disabled Children

Disability Planning

I. Introduction

If assets and income are "available" for basic needs, a disabled person is required to exhaust such resources before seeking means-tested government assistance. In 1993, both Congress and New York passed significant legislation affecting qualification for government programs. The federal legislation addressed Medicaid and codified an exception for self-settled trusts established by a disabled child for his or her own benefit. The New York legislation, EPTL §7-1.2, codified a Court of Appeals decision sanc-

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in 2025, if not repealed earlier, or if not extended. Mr. Biden proposes further tax changes in the fiscal year 2024 Green Book. A summary:

Restore the 39.6 tax rate for married couples whose taxable income exceeds $450,000;

Impose a wealth tax on taxpayers whose net worth exceeds $100 million;

Increase the corporate tax rate from 21% to 28%;

Impose ordinary income tax rates on capital gains to the extent taxable income exceeds $1 million;

Restore the gift and estate tax exemption to $5.3 million;

Limit the GST exemption to direct skips and taxable distributions to beneficiaries no more than two generations below the transferor;

Impose new restrictions on partnership and trust transfers, and to impose tax on transfers currently not subject to tax;

Limit the use of defined value clauses;

Require GRATs to have a minimum term of 10 years;

Make permanent the child care credit enacted in 2021 and make it refundable;

Apply existing securities law rules to transactions involving digital assets;

Limit Section 1031 exchanges to $500,000 per year;

Impose ordinary income treatment on all deductions taken on Section 1250 property for individuals and businesses whose adjusted gross income exceeds $400,000;

Increase the Net Investment Income Tax (NIIT) from 3.8% to 5% for taxpayers with more than $400,000 in earnings;

Impose new restrictions on valuation discounts;

Impose special distribution rules on high-income taxpayers with vested accounts in excess of $10 million.

FULL DISCUSSION OF PRESIDENT BIDEN'S GREEN BOOK PROPOSALS BEGINS ON PAGE 4.

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Tax Outlook

No issue seems to so clearly reveal policy differences between the parties as much as federal taxes. Republicans favor extending the 2017 Tax Act, while Democrats favor letting it expire. President Biden proposes new tax laws aimed at reducing tax expenditures by tightening deductions, increasing tax on corporations, businesses, wealthy individuals, and estates and trusts. Biden will not sign a bill extending the 2017 Tax Act, and Trump will have difficulty getting it extended without Congressional support. Therefore, unless one party controls both houses in 2024 or 2026, federal tax law will remain largely as it was before the Tax Cuts and Jobs Act of 2017 (TCJA) with the exception corporate income tax rate, which will remain at 21%.

In addition to advocating the repeal of TCJA, President Biden also proposes that Congress (i) curtail tax benefits of moderately wealthy taxpayers and imposing higher income tax rates on

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them; (ii) make generational changes to gift and estate taxes; (iii) reestablish a higher corporate income tax rate; (iv) impose new taxes on extremely wealthy taxpayers; and (v) impose various and sundry restrictions new restrictions on corporations, partnerships, trusts, and taxpayer transactions with them.

* * *

The Economy
Under President Biden

Passage of the $1 trillion infrastructure bill in 2021 provided billions of dollars to states and local governments to upgrade outdated roads, bridges, transit systems, airports and other infrastructure projects.

GDP growth rose 5.7% in 2021 in the year following the pandemic, and 2.1 percent in 2022. In 2023, GDP grew at 2% and 2.2% in the first two quarters, and 4.9% in the third quarter. The third quarter increase primarily reflected increases in consumer spending, exports, increased inventories, residential investment, and government spending. (Bureau of Economic Analysis). In comparison, under President Trump, GDP rose between 2.2% and 2.6% in the years before the pandemic and declined 2.8 percent in the year of the pandemic.

Job growth in the past three years has been 3.59% on an annualized basis, resulting in historically low unemployment rates. Annualized job growth under President Trump was 1.49%. (Source: *Facts First*, Presidential Comparison, Trump vs Biden, updated November 10, 2023.)

Sharp Rise, Then Steady
Decline in Inflation in 2020-2023

Mr. Biden's term in office also coincides with the highest level of inflation seen since the early 1980's following the 1979 energy crisis. Inflation has recently abated, but is still above the Federal Reserve's target rate of 2%. The consumer price index (CPI) rose 9.1% for the 12 months ending in June, 2022, 6.5% for the 12 months ending in December, 2022 and has continued to decline in 2023. As of November 14, 2023 CPI rose at a more modest 3.24% for the preceding 12-month period. When Mr. Biden entered office, CPI was 1.4%.

According to the U.S. Bureau of Labor Statistics, the pandemic created market conditions causing prices for goods and services to rise. As the labor market tightened in 2021 and 2022, core inflation rose as the ratio of job vacancies to unemployment increased. Upward wage pressure then passed through to good and services. Backlogs of work orders for goods and services caused supply chain issues.

Recent polls indicate inflation is the most important issue for voters. Inflation was cited by 24% as the single most important election issue. Healthcare, climate and the environment, jobs and the economy, and immigration were each cited by about 10 percent of voters as the single important issue in 2023. (Source: *Statista*, a global data and business intelligence platform.) The federal deficit has continued to increase under Mr. Biden.

Sharp 18-Month Increase in
Interest Rates Beginning in April 2020

The central bank's benchmark short-term rate, currently 5.4%, is at its highest level in 22 years. As recently as April 2020, the benchmark rate was 0.25%. Federal Reserve Chair Jerome Powell, who has defied calls to reduce interest rates because of inflation concerns, believes that inflation is still too high. Mr. Powell recently suggested that higher longer-term interest rates could help slow the economy and cool inflation without further rate hikes. In fact, based on recent favorable CPI data, some economists believe the Federal Reserve might begin cutting short-term interest rates in early 2024. (Morningstar Research Services, LLC).

The 10-year Treasury yield also recently hit a 16-year high of nearly 5% in late October, before retreating to around 4.5% recently. High interest rates adversely affect consumers, businesses and corporations alike, making it more difficult to borrow. Technology companies required to incur debt see growth stifled. The problems caused by high interest rates cascade into the housing, auto, services, transportation, travel, leisure, entertainment, health, technology and virtually all other sectors of the economy.

Recent economic data suggest that consumer spending and job growth are cooling, perhaps as a result of high interest rates and the repayment of student debt.

High interest rates have had a profound effect on the housing market. Since Mr. Biden assumed office, home prices have shot up more than 27%, creating substantial wealth for existing homeowners in a short period of time. Yet the current 20-year fixed rate mortgage at 7.8% has made home ownership much more difficult than as recently as two years ago. High mortgage rates have decreased the number of available homes on the market due the fact that most existing homes subject to mortgages were purchased when mortgage rates were much lower than today.

When the 2-year Treasury yield exceeds the 10-year yield, an "inversion" in the yield curve is said to occur. Past recessions have usually been preceded by an inversion 6 to 24 months earlier. Eight of the last 10 recessions were preceded by an inverted yield curve. The yield curve became inverted in July, 2022 and has remained inverted since. However, the inversion has declined substantially since its high in March of this year. The odds of a recession have correspondingly declined from 65% in the last half of 2022 and the first quarter of 2023, to 46% in the third quarter of 2023. (Bankrate Economic Survey, September, 2023).

The Economy
Under President Trump

During the Trump Administration, the stock market rose sharply and inflation was low. Americans benefitted from low mortgage rates and saw increases in investment and retirement accounts. Lowest-paid wage earners saw significant wage gains.

Comparisons made as of mid-November show that while Trump was President, the Nasdaq rose 53%. Under Biden, the Nasdaq has thus far risen 4.4%. The Dow surged 40% under Trump, compared with 10.6% thus far under Biden. The S&P rose 37% under Trump and 16% to date under Biden. Market gains under President Trump

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continued even stronger market gains seen under President Obama. (Source: *Facts First*, Presidential Comparison, Trump vs Biden.)

The 2017 Tax Act reduced income tax rates for individuals and corporations. TCJA was intended to pay for itself, but ultimately became a large tax expenditure that disproportionately benefitted the most affluent taxpayers who least needed the benefit, and corporations. Shortly before leaving office, Mr. Trump signed a $900 billion bill providing pandemic relief. Covid-related stimulus caused the deficit to increase substantially in the final months of 2020. By the time President Trump left office, the national debt had risen to $28 trillion, $8 trillion more than when Mr. Trump entered office.

Relevance of Age in
<u>Presidential Elections</u>

Age of a President is a peculiarly difficult factor to assess, since many desired Presidential attributes improve with age. An older President might rely more on wisdom and experience than would a younger President. There appears to be no easily discernable trend in the age of Presidents since 1960, although Biden and Trump are at the high end of the spectrum. Biden was 78 when inaugurated, Trump was 70, Reagan was 69, H.W. Bush, 64, Ford, 61. Nixon 56, LBJ 55, George Bush 54, Carter, 51, Obama 47, Clinton 46, and Kennedy was 43.

Younger as well as older Presidents have delegated important matters to others in their Administration. Vice President Cheney was entrusted with significant policymaking decisions by President Bush. President Reagan delegated many foreign policy matters for six and a half years to Secretary of State George Shultz, as did Nixon to Kissinger.

* * *

Mr. Trump's Resume
<u>Entering The 2024 Election Cycle</u>

Mr. Trump's accomplishments in foreign affairs were notable: He ended the disastrous Iran agreement, consummated the Abraham Accords, and put allies on notice that the U.S. would not continue to disproportionately pay for the defense of Europe, as well as Korea and Japan. Some now acknowledge his tariffs on China, criticized at the time, may have been instrumental in bringing jobs and manufacturing back to the U.S.

As he seeks the Presidency at age 78, Mr. Trump finds himself enmeshed in a spate of legal problems of his own creation. He recently made several gaffes in which he confused world leaders and former Presidents. Governor DeSantis quipped that Mr. Trump had "lost the zip on his fastball." Even if Mr. DeSantis is correct, Mr. Trump still appears cognitively sharp.

Mr. Biden's Resume
<u>Entering The 2024 Election Cycle</u>

President Biden's recent response to what Senator Graham described as "medieval atrocities" committed by Hamas have earned bipartisan praise and demonstrated judgment and wisdom burnished over a long Senate and White House career. Despite pressure from some foreign leaders and domestic protesters who trivialize Israel's right to defend itself, Mr. Biden has shown steely resolve in mobilizing the military power of the U.S. against regimes whose only real goal is to destroy Israel.

Passage of the infrastructure bill addressed needs that had long gone unmet. Job growth has been strong, and unemployment has declined to historic levels. The President met with foreign leaders and reestablished America's role as leader of the free world. He addressed climate change. Inflation has been painfully high, but has finally receded. Interest rates remain the highest in recent memory, putting pressure on all sectors of the economy.

If reelected, Mr. Biden will be 86 at the end of his second term. He exhibits memory issues consistent with some men of his age. Yet he also possess excellent judgment and a lifetime of Washington experience. His relationship with former Senate colleagues is an important asset in passing future legislation. Mr. Biden is honest and trustworthy. Older Presidents have found their own way in managing the Office. If he is nominated, the electorate will determine whether Mr. Biden is able to meet the demands of the Oval Office for several more years.

* * *

Full discussion of President Biden's Green Book proposals begins Here.

President Biden's Revenue Proposals for Fiscal Year 2024

The 2024 Green Book reiterates several previous proposals (i) increasing the corporate tax rate to 28% from 21%, (ii) increasing the tax burden on some high income and high wealth taxpayers, (iii) eliminating the step-up in basis at death for estate tax purposes, making death a realization event, (iv) reducing the current gift estate tax exclusion to $5 million; and (v) eliminating current fossil fuel incentives.

New proposals contained in the 2024 Green Book include proposals (i) restoring the 39.6% tax rate on high income taxpayers and imposing a minimum tax on taxpayers whose net worth is over $100 million; (ii) effecting several restrictive changes to the grantor trust rules, one of which would be to recognize for income tax purposes transfers that are currently ignored; (iii) restricting valuation discounts; (iv) preventing basis-shifting through partnerships; (v) recharacterizing straight-line depreciation recapture as ordinary income (for certain taxpayers); (vi) changing cryptocurrency reporting requirements; (vii) taxing capital gains at ordinary income rates for taxpayers whose income exceeds $1 million; and (viii) requiring IRA distributions from accounts whose value exceeds $10 million.

Fate of Tax Cuts and Jobs Act (TCJA)

As part of his 2024 budget proposal, Mr. Biden seeks to reverse most changes made by TCJA (that were not permanent) by reversing them legislatively, or by letting the changes expire. Mr. Biden would also impose several new taxes either directly dependent on wealth, or having a close nexus to

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wealth.

Individual Income Tax Rate

Mr. Biden favors restoring the 39.6 percent tax rate for married couples with taxable income above $450,000. TCJA lowered the top rate to 37 percent. He also seeks to treat death as a realization event, which would eliminate the need for the current basis step-up. He also favors eliminating the basis step-up, which appears redundant. The *Moore* case, soon to be decided by the Supreme Court, could influence that proposal.

Wealth Tax

The Biden Administration proposes a new tax based on the wealth of extremely affluent taxpayers. Individuals whose net worth exceeds $100 million would be subject to a minimum tax of 25% imposed on total "economic" income comprised of taxable income and unrealized capital gain. Annual reporting requirements would be imposed on taxpayers whose net worth exceeds the threshold. Taxpayers would be required to provide a description of assets, liabilities, and basis information.

The tax would be payable in installments over nine years in the first year of the new law, and in five years in succeeding years. It would be a "prepayment" of capital gains tax. Deferral would be available to taxpayers more than 80% of whose wealth consists of illiquid assets. However, deferral would be subject to a deferral charge not exceeding 10% of unrealized gains.

Corporate Tax

¶ The Green Book proposal would increase the corporate tax rate enacted during the Trump Administration from 21% to 28%. The change would be projected to generate $1.3 trillion over 10 years. The tax on corporate stock repurchases, enacted as part of the Inflation Reduction Act in 2022, would be increased from 1% to 4%. That provision is projected to raise $238 billion over 10 years.

¶ The current definition of "control" for purposes of transfers under Section 351 as well as the reorganization and spin-off provisions requires ownership of at least 80% of the corporation's voting stock and at least 80% of each class of nonvoting stock. The Green Book proposal would require ownership of 80% or more of both a corporation's voting stock and value.

Medicare, Medicaid and Social Security

In his 2021 budget proposal, President Trump proposed deep healthcare spending cuts over the next decade, especially to Medicaid and costs incurred under the Affordable Care Act. His proposal requested $94.5 billion for the Department of Health and Human Services, a 10% decrease from the 2020 enacted level. Mr. Trump also spoke of protecting Social Security and Medicare, and reducing insurance premiums. While President, Mr. Trump, with some success, ended "surprise" billing from health care providers. However, his attempt to reduce drug prices did not show significant results.

Mr. Trump, like Mr. Biden, appears to favor making no changes to Medicare and Social Security, a position which aggravates some Republicans. The former President criticized Presidential aspirant Governor Nikki Haley for past comments which appear to support making changes to Medicare and Social Security. Mr. Trump warned congressional Republicans not to disturb Social Security or Medicare as a part of the debt ceiling debate: "Under no circumstances should Republicans vote to cut a single penny to help pay for Joe Biden's reckless spending spree."

Mr. Biden has had some success in reducing drug prices, having capped the cost of insulin at $35 for seniors on Medicare. He favors giving Medicare the power to negotiate drug prices. With respect to Social Security and Medicare, he stated in February:

> I will not cut a single Social Security or Medicare benefit. In fact, I'm going to extend the Medicare trust fund for at least two decades. And we'll not raise taxes on anyone making over 400,000 grand. And I'll pay for it all, my proposals, by making the wealthy and big corporations pay just a little bit more.

Capital Gains

Mr. Biden favors imposing the ordinary income tax rate, rather than the long term capital gains rate of 20 percent, on capital gains and qualified dividends to the extent the taxpayer's taxable income exceeds $1 million. He does not appear to favor altering the current capital gains tax on other taxpayers. Mr. Trump has in the past advocated for a reduction in the capital gains tax rate. In 2020, he stated: "I'm going to do a capital gains tax cut to 15% in the second term. . .We're going to get it down to 15%. It's at 21%. We'll get that down to 15%.

Gift and Estate Taxes

¶ The current "portable" federal gift and estate tax exemption of $12.92 million will "sunset" on January 1, 2026, when it will revert to 2017 levels of about $5.3 million. The Administration favors an increase in the estate tax rate from 40 to 45 percent, and supports reducing the exemption amount to pre-TCJA levels of $5.3 million per person and $10.6 million for married couples.

¶ The Green Book also proposes eliminating the basis step-up at death, and imposing capital gains tax at death on appreciated assets. Either change would appear to accomplish the same result. Those gains could be offset with capital losses and carryforwards, and remaining capital gains could be deducted against the estate tax. A $1 million per-person exclusion for unrealized capital gains transferred by gift or held at death would be available.

¶ The $17,000 annual exclusion would be eliminated, replaced by a new per-donor annual limit of $50,000. A new category of transfers to trusts, to interests in passthrough entities, and of partial interests in property would be cre-

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ated. The present interest requirement would be eliminated.

Generation-Skipping Transfer Tax

Under current law, a GST allocation to a trust may continue for many generations without being taxed. Distributions to grandchildren and more remote descendants may be made without incurring a GST tax. The Green Book would eliminate this planning opportunity.

¶ The proposal would limit the GST exemption to direct skips and taxable distributions to beneficiaries no more than two generations below the transferor.

¶ Trusts would be required to report on its income tax return the generation-skipping transfer (GST) tax inclusion ratio of the trust whenever a distribution is made to a non-skip person.

¶ Trust loans to beneficiaries would be recharacterized as distributions for income and GST tax purposes.

Trusts & Partnership Transfers

The 2024 Green Book imposes new restrictions on trusts:

¶ Transfers to or from partnerships or trusts would as deemed recognition events (unless the trust is a revocable trust).

¶ The proposal would change existing law, and treat income tax payments made by the grantor of an irrevocable grantor trust as a taxable gift.

¶ Asset transfers between the grantor and the grantor trust would no longer be nontaxable events. Capital gain, but not loss, would be recognized on sales or exchanges between the grantor and the grantor trust. Rev. Rul. 85-13, which practitioners have long placed heavy reliance upon in tax planning, would in effect be revoked.

¶ The proposal would require all trusts (domestic and foreign if administered in the United States) with an estimated value over $300,000 at the end of a taxable year or $10,000 of income (in each case, indexed for inflation) to report information about its grantor, trustees, and "general information" to the IRS.

Defined Value Clauses

The Greenbook proposal would curtail the use of formula clauses when making gifts of interests of difficult-to-value assets. The rule would apply on to property in which the family has at least a 25% interest. The proposal would require that a defined value formula clause be based on a variable not requiring IRS involvement.

A defined value formula clause would be effective (i) if the value were determinable by an appraisal within a reasonably short time before or after the transfer; or (ii) in situations where the defined value formula clause is used for the purpose of defining a marital or exemption equivalent bequest at death based on the decedent's remaining transfer tax exclusion.

GRATS

Under the Green Book proposal, Grantor Retained Annuity Trusts would be required to have a minimum term of 10 years, and a maximum term equal to the grantor's life expectancy plus 10 years. The remainder interest of a GRAT would be required to have a value equal to the lesser of (i) 25 percent of the value of the assets contributed or (ii) $500,000, but not greater than the value of the assets contributed.

IRC Section 199A

TCJA allows owners of partnerships, limited liability companies, and other pass-through entities to deduct 20 percent of business income through a "qualified business income deduction." IRC. §199A. *See A Journey Through IRC Sec. 199A: Wasn't the Code to be Simplified*, Tax News & Comment, August 2019. The deduction was intended to level the playing field for business owners operating in non-corporate form to keep pace with the significant corporate tax cut also provided by the Act. President Biden's Green Book proposal is silent on Section 199A, but Mr. Biden campaigned on limiting Section 199A. If the corporate tax rate were increased to 28%, the rationale for Section 199A would be somewhat diminished.

Child Care Credit

Mr. Biden proposes to make the increased temporary credit provided by the American Rescue Plan (ARP) enacted in 2021 of $3,600 per year permanent, and make it refundable. According to the U.S. Census Bureau, the credit resulted in a historic reduction in child poverty. The legislation, enacted early in the Biden presidency, narrowly passed the House by a vote of 220-211.

Cryptocurrency & Digital Assets

The Green Book proposal does not change the current treatment of cryptocurrency as property for federal income tax purposes, and does not address fundamental tax issues concerning digital assets. However, the Administration seeks to ensure that digital assets do not escape reporting and other tax rules. Therefore the proposal seeks to import some existing securities law rules to digital assets.

The proposal would (i) extend the wash sale rules and Section 475 mark-to-market rules to digital transactions; (ii) require U.S. brokers and digital asset exchanges to report information on substantial foreign owners of digital assets under the Foreign Account Tax Compliance Act (FATCA); and (iii) impose IRS reporting requirements under IRC §6038D on individuals who own at least $50,000 in foreign financial assets.

Like-Kind Exchanges

The Green Book would further restrict like kind exchanges by limiting deferral of gain under Section 1031 to $500,000 per year. Taxpayers would also be required to recognize gain in excess of the $500,000 limit in the year the property is exchanged. The exclusion would be $1 million for married couples.

The further reduction in limita-

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tion could cause taxpayers exchanging low-basis property to rethink exchanges where realized gain exceeds the exclusion amount, since a current tax liability would result despite the receipt of no cash. For example, if the taxpayer wishes to exchange property worth $650,000 whose basis is $50,000 for property of the same value, only $500,000 of the $600,000 realized gain will be deferred. The taxpayer will have a current short term capital gain of $100,000. In this situation, some taxpayers might decide to forego the exchange rather than pay capital gains tax on $100,000 of short-term gain.

Both Republicans and Democrats have long supported the elimination of the like-kind exchange provision, considering it a costly tax expenditure. As part of the Tax Cuts and Jobs Act of 2017, personal property exchanges were eliminated from qualification under Section 1031, leaving only real property.

Depreciation Recapture

IRC §1250 property (buildings and some other depreciable real property) on which depreciation deductions in excess of the straight-line method have been taken are subject to ordinary income to the extent of the excess. The Green Book proposal would impose ordinary income treatment to <u>all deductions taken on Section 1250 property held for more than one year</u>. Since most deductions are now straight-line and have been for years, this provision would affect most noncorporate holders of depreciable real estate. Gain in excess of depreciation recapture would continue to be treated as Section 1231 gain.

Note: <u>This proposal would apply only to individuals and businesses with adjusted gross income of 400,000 or more</u>. For taxpayers under this threshold, unrecaptured Section 1250 gain would continue to be taxed at 25%.

Net Investment Income Tax

The Administration has proposed increasing and expanding the reach of the Net Investment Income Tax (NIIT or "Medicare tax") in order to fund Medicare. The proposal would increase the net investment income tax from 3.8% to 5% for taxpayers with more than $400,000 in "earnings," which would include regular income, capital gains, and pass-through business income. If the top income tax rate is increased to 39.6%, those subject to both taxes would incur a federal tax of 44.6%.

Valuation Discounts

Valuation discounts for lack of control and lack of marketability would be restricted. This would be accomplished by valuing partial interests in nonpublicly traded property transferred to or for the benefit of a family member as (merely) a pro rata share of the aggregate interests in the property held by the family. The rule would apply only to property in which the family has at least a 25% interest.

Required IRA Distributions

The Green Book proposal would impose special distribution rules on high-income taxpayers with aggregate vested account balances under tax-favored retirement accounts in excess of $10 million. A minimum distribution of 50% of the excess would be required for the preceding calendar year. If the high-income taxpayer's aggregate vested account balance exceeds $20 million, then the required distribution is subject to a floor, which would be the lesser of (a) that excess and (b) the portion of the taxpayer's aggregate vested account balance that is held in a Roth IRA or designated Roth account.

FROM THE COURTS, CONT.

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sions."

Although the case was decided unanimously by three circuit court judges, four judges dissented from a denial for a rehearing en banc, with one dissenter noting that the Ninth Circuit had become "the first court in the country to state that an 'income tax' does not require that a "taxpayer has realized income."' Judges Bumatay, joined by Judges Ikuta, Callahan, and VanDyke stated that the Court erred in disregarding the realization requirement of the Sixteenth Amendment "without offering any other limiting principle."

* * *

Four Supreme Court Justices must agree to hear a case on certiorari. Had certiorari not been granted, the decision of the Ninth Circuit would have effected changes to existing tax law with respect to when income is subject to tax. While the decision is controlling law only in the Ninth Circuit, nearly one-fifth of the population of the U.S. resides in that "activist" circuit.

As the dispute reaches the Supreme Court, the case has spawned numerous amicus curiae briefs by interested parties, with some warning that the case has immediate implications for proposed changes to the taxation of capital gains found in the Biden Administration's Green Book containing the President's proposed budget for fiscal year 2024, and also for a "wealth tax" imposed on unrealized income of ultra-high income taxpayers.

There appears to be a legitimate question of whether the holding — even if it was correct — went too far in raising and deciding Constitutional issues that were not necessary to reach the result which it did. If so, the Ninth Circuit may have exceeded its jurisdiction. If the Supreme Court were to so find, then part of the rationale as stated by the Ninth Circuit could be truncated from the decision as mere dicta even if the high Court upheld the result.

It is certainly improbable that the Ninth Circuit — or any appeals court for that matter — would or could render decades of established tax law obsolete merely by affirming a lower court's decision to dismiss a case. Dismissal ensues when a court determines that the complaint has no merit, fails to state a cause of action, that there is no triable issue of fact, and therefore no legal issue requiring court resolution. When deciding a motion to dismiss, the tribunal must assume all pleaded facts are true.

In the instant case, the government was not required to answer the taxpayer's complaint, since the complaint was dismissed. In fairness, the Ninth Circuit was not the court dismissing the case, it merely affirmed dismissal by the Washington district court. Still, the Ninth Circuit took the ball and ran: It took the opportunity to attempt to make generational changes to the tax law in affirming the dismissal. To illustrate the vexing problem engendered by the decision, one could argue that the decision of the district court could well have been affirmed per curiam, without the Ninth Circuit issuing an opinion.

This is not to say that the Ninth Circuit was wrong to affirm. However, the Ninth Circuit may have overstepped its bounds in coaxing unjustified and unsettling interpretations out of longstanding doctrinal case law while at the same time rendering a decision that was correct. The Court seems to "bootstrap" its apocryphal warning concerning the fate of the tax law were it not to affirm the dismissal, with its own questionable reading of established case law. The Court's dismissal not on the merits seems of questionable juridical prudence. The conclusion of the Court as to the importance of its decision seems to prove too much:

> [H]olding that Subpart F is unconstitutional. . .would also call into question the constitutionality of other tax provisions that have long been in the books. *(See* Bruce Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1,52 (1999))

The Supreme Court may have decided to hear the case to put the genie back in the bottle, and decide the case on grounds not involving the Constitution. It would not be surprising if the high court objected to the Ninth Circuit's reversing, sub silentio, decades of case law establishing settled doctrines involving the requirement of realization, which the Ninth Circuit took it upon itself to vanquish in the blink of an eye.

While a colorful thought, it is simply not true — as the Ninth Circuit surmised — that a contrary result would upend the tax law. A contrary result would find the contested statute invalid but would not require draconian changes to the tax law envisioned by the Ninth Circuit. Much of the opinion appears to be dicta camouflaged as holding. (Dicta refers to an opinion expressed by a court that is not necessary to resolve the case, and as such is not legally binding and is nothing more than persuasive authority in future litigation.)

The existential musings of the Ninth Circuit are captivating, but will likely be brought back to earth by a somber Supreme Court.

<u>Alito Recusal Request Intrigue</u>

On August 3, Minority Whip Dick Durbin (D-IL), joined by nine other Democratic Senators, including Senators Feinstein (Late, CA), Klobuchar (MN), Coons (DE), Blumenthal (CT), and Booker (NJ), sent a letter to Chief Justice Roberts requesting that Justice Alito be recused based on an interview in the Wall Stret Journal in July. The interview involved David Rivkin, an attorney representing the taxpayer-petitioners in *Moore*. Senator Durbin argued that by sitting for the interview, Justice Alito created "an appearance of impropriety."

Justice Alito, who has recused himself in 46 cases this year, more than any other Justice, responded "[t]here is no valid reason for my recusal," adding:

> When Mr. Rivkin participated in the interviews and co-authored the articles, he did so as a journalist, not an advocate. The case in which he is involved was never mentioned; nor did we discuss any issue in that case either directly or indirectly.

Rivkin is a partner in the Washington firm Baker Hostetler. A noted conservative political commentator, he

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served in the administrations of H.W. Bush and Reagan.

* * *

II. Facts and Procedural Setting

Tax commentators have ascribed profound, even "existential" importance to the case, elevating its status to the most important tax decision of the century. The dispute involves the Constitutionality of IRC Sec. 965, part of sweeping corporate tax cuts made under the Tax Cuts and Jobs Act of 2017, signed into law by President Trump. Under the Act, the tiered corporate tax rate was changed to a flat 21 percent. The international corporate tax system was changed from "global" to "territorial" to discourage "tax inversion."

[Inversion occurs where the domestic parent is replaced by a foreign parent, with the domestic parent becoming a subsidiary of the foreign parent, in the process changing its tax residence to a foreign country. The government estimates the MRT will generate $340 billion in tax revenue.]

Taxpayers invested in a controlled foreign corporation (CFC), which is a foreign corporation whose ownership and voting rights are more than 50 percent owned by U.S. persons. At issue in the case was a one-time Mandatory Repatriation Tax ("MRT") of 8 percent imposed on overseas earning and profits that had never been taxed, and 15.5 percent on retained cash.

Any U.S. person owning at least 10 percent of a CFC was required to include their pro rata share of the CFC's post-1985 earnings and profits on their 2017 tax return. It was thought that the low rate on repatriation would encourage multinationals to bring cash back to the U.S. In fact, many multinational corporations did repatriate earnings. The issue facing the Ninth Circuit on appeal was whether the repatriation tax qualified as an "income tax" under the Sixteenth Amendment, thus avoiding the "direct tax" proscription in the Apportionment Clause of the Constitution.

The plaintiffs were not large multinational corporations, but rather individual taxpayers who were 11 percent owners of a controlled foreign corporation which supplied tools to farmers in India. Section 965 deems the accumulated post-1986 deferred foreign income of certain foreign corporations, including CFCs, to be Subpart F income for 2017. Accordingly, the taxpayers' tax liability was increased by about $15,000 by the MRT.

The taxpayers appealed from dismissal of their complaint by the Washington district court to the Ninth Circuit Court of Appeals in San Francisco, which affirmed. The present appeal ensued.

The Supreme Court now has a conservative bent. Justices Thomas and Alito are the most conservative Justices, followed by Justices Gorsuch and Barrett who are less conservative. Chief Justice Roberts and Justice Kavanaugh are conservative, but sometimes vote with the three liberal Justices, Sotomayor, Kagan, and Ketanji Brown Jackson. Chief Justice Roberts — who dissented in the recent decision reversing *Roe v. Wade* — seems to have assumed the mantle of former Justice Kennedy as a swing vote on the Court. Justice Kennedy, a centrist, during the 2008-2009 term voted with majority 92 percent of the time.

III. The Parties' Arguments

The taxpayers argued that the term "income" comprehends an "undeniable accession to wealth that is clearly realized, over which the taxpayer has complete dominion." For realization to occur, some type of consideration – something of value – must be received. A mere appreciation in value of property cannot be a realization event for tax purposes. The earnings and profits on which the MRT was imposed had accrued before the taxpayer owned the stock. Finally, the MRT was not an income tax, the CFC's income had not been distributed to them, and that unrealized income was not within the common understanding of "income" when the Sixteenth Amendment was adopted.

The government repeated successful arguments made in district court and noted that the foreign corporation had actually realized income. The MRT was consistent with the Apportionment Clause which exempts income. There is no constitutional ban on Congress disregarding the corporate form to facilitate taxation of shareholder's income. Thus, there was no prohibition in disregarding the corporate form to impose taxation since taxpayers had some ability to control corporate distributions. Finally, the MRT did not violate the Due Process Clause even though it was retroactive, since it served a legitimate purpose.

IV. The Ninth Circuit's Decision

The Ninth Circuit identified two constitutional issues: First, whether the MRT violated the Apportionment Clause of the Constitution; and second, whether it violated the Due Process clause. The Court preliminarily noted several "basic principles." First, Congress' power to collect tax was "a central force behind the Constitution." *See Hylton v. United States*, 3 U.S. (3 Dall.) 171, 173 (1796); and second, the Constitution gives Congress the power "[t]o make all Laws which shall be necessary and proper for carrying into Execution for foregoing Powers…" U.S. CONST. art. I, § 8, cl. 18; *see also McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 323-25 (1819). The Court concluded: "Once the federal government decides to tax something . . . its power to tax . . . must necessarily be broad.

<u>No Violation of Due Process</u>

In addressing the taxpayers' argument that the retroactive nature of the legislation violates the Due Process Clause, the Ninth Circuit, finding no Due Process violation, noted that while retroactive legislation may violate the Due Process clause, and there exists a presumption against retroactivity, retroactive tax legislation is often constitutional. The Court cited to *U.S. v. Carlton*, 512 U.S. 26, 30 (1994). ["The Supreme Court] repeatedly has upheld retroactive tax legislation against a due process challenge."]

No Violation
<u>of Apportionment Clause</u>

The Apportionment Clause of the Constitution provides that any "direct tax" must be apportioned "so that each state pays in proportion to its

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population." The Court disposed of the Apportionment Clause argument, remarking that the Sixteenth Amendment clearly "overruled" the result in a case which found that income from personal property was subject to the Apportionment Clause, and that the Amendment "further reinforc[ed] the narrow reach of the Apportionment Clause." *Nat'l Fed'n of Indep. Bus. v. Sebekius*, 567 U.S. 519 at 571 (2012); *see also Pollock v. Farmers' Loan & Tr. Co*., 158 U.S. 601, 618 (1895).

[A direct tax is a tax imposed on a person or property as distinct from a tax imposed on a transaction, which is an indirect tax. Sales tax is an example of an indirect tax. The Sixteenth Amendment, ratified in 1909, exempted from the apportionment requirement the category of income. Section 61 of the Code now provides that gross income includes income from "whatever source derived, including (but not limited to)" [an expansive enumerated list of common income items].]

Similar Taxes Have
Been Found Constitutional

After noting the apportionment clause no longer stood as a bar to taxing income, the Court acknowledged "the difficulty in defining income," but noted that "taxes similar to the MRT are constitutional." *Garlock Inc. v. Comm'r*, affirmed the Tax Court's decision that a CFC's Subpart F income was attributable to shareholders even if that income had not been distributed, and found that the argument it is unconstitutional "borders on the frivolous." 489 F2d 197, 202 (2nd Cir 1973).

The Court then cited to *Heiner v. Mellon*, where the Supreme Court held that "whether or not a partner's share of the net income of the partnership was distributable was not material to whether it could be taxed." 304 U.S. 271, 281 (1938). Up to this point, the Ninth Circuit opinion was coherent and made sense. It is the conclusion which the Court then drew from *Helvering v. Horst*, 311 U.S. 112, 116 (1940) where the opinion began to unravel.

The Ninth Circuit's Misstep in *Horst*

In *Horst*, father detached negotiable interest coupons for bonds shortly before maturity and gave them to his son. The case was an assignment of income case controlled by *Lucas v. Earl*, 281 U.S. 11 (1930). The Supreme Court held that under the doctrine of realization, the interest was taxed to the donor, and not to the son who cashed the coupons.

Citing *Horst*, the Ninth Circuit concluded that (i) "the Supreme Court has made clear that realization of income is not a constitutional requirement;" and (ii) "the rule that income is not taxable until realized. . .[is] founded on administrative convenience." Neither of these conclusions is supported by *Horst*, and the first conclusion does not even rise to the level of being specious.

That realization is not a constitutional requirement is never discussed in the short *Horst* opinion. In fact, the opinion never gives any indication that the Court believes realization is anything but a constitutional requirement.

The second quote concerning "administrative convenience," actually stands for the opposite proposition that realization is a constitutional requirement. It is puzzling that the Court cites to *Horst* at all, since the case flatly contradicts the Court's legal conclusion. The Ninth Circuit's implausible reading of *Horst* is evident if one reads the entire excerpt in *Horst* referring to "administrative convenience":

> In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. Cf. *Aluminum Castings Co. v. Routzahn*, 282 U. S. 92, 282 U. S. 98. (Emphasis added).

After this astonishing misstep, the opinion then regains its stride and citing to *Dougherty v. Comm'r*, 60 T.C. 917, 928 (1973) observes that there is no constitutional ban on disregarding the corporate form to facilitate tax on shareholder income: The MRT "builds upon these U.S. persons' preexisting tax liability attributing a CFC's income to its shareholders."

MRT Did Constitute "Income"

The Court then addressed the taxpayers argument that the MRT did not constitute "income." The taxpayers urged that the Court adopt the definition of income as found in *Eisner v. Macomber*, 252 U.S. 189, 219 (1920), and *Comm'r. v. Glenshaw Glass Co*. *Glenshaw Glass* defined income as (i) an undeniable accession to wealth; (ii) clearly realized; and (iii) over which the taxpayers have complete dominion. 348 U.S. 426, 429 (1955). However, the Ninth Circuit found that *Macomber* was inapplicable since that case only described what "[i]ncome may be defined as." (Emphasis added). Similarly, *Glenshaw Glass* reiterated *Macomber* and allowed that while the definition was useful, "it was not meant to provide a touchstone for all future gross income questions."

The Court then repeated its unjustified mantra from *Horst* that the concept of realization was "founded on administrative convenience," as if repeating it augmented its legal persuasiveness. In reading the repetition of the Ninth Circuit's unfounded belief that the doctrine of realization is founded on administrative convenience, one is reminded of an aphorism attributed to Abraham Lincoln: He is said to have been asked how many legs a horse has, if one calls a tail a leg, to which Lincoln responded, "four, calling a tail a leg doesn't make it one."

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V. Dissent to Order Denying Rehearing

A scathing dissent to a refusal by the Court in response to taxpayers request for a rehearing en banc (i.e., by the full court) laid bare the defects of the majority opinion. As noted, Judge Bumatay correctly stated that the Ninth Circuit became the "first court in the country" not to require realization under the Sixteenth Amendment. The dissent noted that while the Supreme Court has allowed "flexibility" in defining "income," it had never "abandoned" the realization requirement. Even worse, dispensing with realization "without offering any other limiting principle," risked expanding federal taxing power "beyond the limits placed by the Constitution."

Judge Bumatay cites *Macomber* as the "seminal case" establishing the realization requirement for "income" and posits that no post-*Macomber* case "indicated the slightest relaxation of the realization requirement for income," and concluded that

> [b]ased on text, history, and precedent, our court erred in disregarding the realization requirement. . . Rather than hewing to plain meaning and Supreme Court rulings, we recast the very meaning of 'income.'

Warning that without the "guardrails" of the realization requirement, the government has "unfettered latitude" to "redraw the boundaries of its power to tax…"

The dissent agreed that the *Moores* received no return on their investment, and had no power to direct a dividend payment or otherwise realize gain. Since the *Moores* had no "control over" the company nor any "realizable economic value from it," the Court should have concluded that the *Moores* had not received any income from the corporation. The error should have been corrected en banc. The failure to properly "divorce" income from realization "open[ed] the door" to new federal taxes on wealth and property.

VI. Analysis

The Supreme Court grants fewer than one percent of certiorari requests. Given the small amount in controversy, there is little doubt that the Court felt compelled to hear this case. That desire may come from those Justices who are inclined to void the MRT, or from those who are inclined to uphold the MRT, or from those who are either inclined to uphold the MRT or to void it, but who believe as did the dissent, that "errors" concerning realization needed correction.

It is doubtless true that dispensing with realization could result in seismic changes to the entire federal tax law regime. However, such draconian changes would still require the imprimatur of Congress, which seems remote. If the Supreme Court affirms, then it will have the opportunity to correct what Judge Bumatay stated was the failure of the Ninth Circuit in disregarding the realization requirement "without offering any other limiting principle." If it reverses, the reversal will likely not be on Constitutional grounds, since the Ninth Circuit's resort to Constitutional arguments in affirming violated the Constitutional Avoidance Doctrine. Nevertheless, on whatever grounds the Supreme Court reverses, if it does reverse, it will likely disabuse the Ninth Circuit of its notion that the realization doctrine is one of administrative convenience.

* * *

Although influential, the Ninth Circuit is also the Circuit most often reversed. Twelve of the October 2021 term cases heard by the Supreme Court originated in the Ninth Circuit, the most from any Circuit. All 12 cases were reversed. Since 2007, the activist Ninth Circuit has had a reversal rate of 80.4 percent. In the same period, the 2nd Circuit (NY, CT, VT) had a reversal rate of 65 percent; and the conservative 5th Circuit (TX, LA, MS) had a reversal rate of 72.4 percent.

Given the Supreme Court's lack of deference to appeals originating in the Ninth Circuit, it would not be surprising were the Supreme Court to reverse. Nor would it be surprising if there were concurring and dissenting opinions all discussing the realization requirement.

If the Ninth Circuit is reversed and the MRT vanquished, then the musings of the Ninth Circuit dispensing with the realization requirement would be vanquished along with the MRT, since the case would no longer be res judicata. If the Court were to affirm, it could truncate the erroneous portions of the opinion. In affirming on different grounds, the Court could find that the MRT is simply an example, or possibly an extension, of existing law where the taxpayer is taxed on entity income.

* * *

Constitutional Avoidance Doctrine

A basic tenet of Constitutional law is that cases should not be decided on Constitutional grounds if the case can be decided on other grounds. The Constitutional Avoidance Doctrine provides that Federal courts should interpret the Constitution only when it is a "strict necessity." Justice Brandeis, concurring in *Ashwander v. Tennessee Valley Authority*, stated:

> Considerations of propriety, as well as long-established practice, demand that we refrain from passing upon the constitutionality of an act of Congress unless obliged to do so in the proper performance of our judicial function, when the question is raised by a party whose interests entitle him to raise it. . . .The Court will not pass upon a constitutional question, although properly presented by the record, if there is also present some other ground upon which the case may be disposed of. . . Thus, if a case can be decided on either of two grounds, one involving a constitutional question, the other a question of statutory construction or general law, the Court will decide only the latter. [Citations omitted].

297 U.S. 288 at 296, 297, (1936).

It appears the Ninth Circuit ignored this doctrine inasmuch as the decision appears to have unnecessarily implicated the Constitution when the case could have been decided on deci-

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sional law. It is indeed lamentable that a Circuit Court of Appeals could so misread clear case law and arrive at a palpably incorrect legal conclusion with respect to the realization requirement. It is also disappointing that a Court of Appeals would violate the Constitutional Avoidance Doctrine by invoking, albeit indirectly, the Constitution to justify such a meritless legal conclusion.

VII. Conclusion

The importance of realization will likely be underscored by the Supreme Court. Its meaning has evolved over decades of statutory enactments and regulatory and judicial interpretation. Admittedly, the concept of realization has proven somewhat elusive. What constitutes "income" in Code Sec 61 is also fairly nebulous; i.e., "*Gross income means all income from whatever source derived*." However, many decades of decisions have "found" the meaning of "realization" and "income."

Like Heisenberg's uncertainty principal, there may be a limit to how precisely we can define realization without causing a concomitant loss of certainty in other tax areas, perhaps what constitutes "income." In any case, there is no dispute that the doctrine of realization plays a fundamental role in ensuring the cohesion Subtitle A, which governs income taxes.

Whether the MRT will survive Supreme Court scrutiny is difficult to predict. Abolishing the MRT would result in the government forfeiting of billions of dollars of tax revenue already collected from large multinational corporations. On the other hand, sustaining the MRT would further widen the scope of what can be taxed as "income." The Ninth Circuit seldom emerges from Washington unscathed, which suggests the fate of the MRT may be inauspicious.

In any case, the dire consequences envisioned by some appear unjustified, since the Supreme Court will in all likelihood reject the Ninth Circuit's view that the realization is a doctrine of administrative convenience.

The Ninth Circuit may be correct that eliminating the realization requirement would remove existing barriers to taxing property appreciation, but elimination of the requirement by the Supreme Court in its review is barely within the realm of possible outcomes.

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point subsequent increases in the taxable estate are no longer taxed at 190 percent, but rather at rates of about 13 or 14 percent. Thus the moniker "cliff."

The exemption of $626,352 is entirely phased out once the taxable estate reaches $6.909 million, which is exactly five percent more than $6.58 million. An increase in the taxable estate of only $329,000 results in a disproportionate estate tax liability of $626,352. The 5% increase ($329,000/ $6,580,000) in the taxable estate above $6,580,000 is taxed at 190.4% ($626,352/$329,000).

Percentagewise, the worst effects of the "cliff" are felt at the beginning: The first $20,000 over the exemption amount is taxed at 265%. Yet tax planning is also important throughout the phaseout: A $109,000 increase from $6.8 million to the point at which the phaseout is complete at $6.909 million is still taxed at a confiscatory rate of 117%.

After the taxable estate reaches $6.909 million and accrues a tax liability of $626,352, incremental increases in the relative rate of tax imposed decline dramatically. However, with taxable estates of that size, even small percentage increases in tax rates equate to large absolute tax increases. A $1 million increase in the size of the taxable estate from $7 to $8 million is taxed at 13.52%, resulting in a tax of $135,200. [New York has a graduated estate rate beginning at 3.06 percent increasing to 16 percent.]

The New York tax denies any use of the exemption for large estates; the exemption is a wasting asset. However, it is true that estates above the phaseout do benefit indirectly from the exemption. In both relative and absolute terms, tax planning for taxable estates within the phaseout benefit most from tax planning. That translates to taxable estates between $6.58 million and $6.909 million. It may well be the case that the taxpayer may not be able to reduce a taxable estate of $6.909 million to a taxable estate of $6.58 million to entirely reduce the estate tax. However, the descent from the edge of the cliff, which begins at $6.58 million is long. Any reduction within the 5 percent "window" will save more than one dollar in tax for every dollar the taxable estate is reduced. The first $20,000 over the cliff is taxed 265%, the last $109,000 before the phaseout is complete is taxed at 117%. The entire $329,000 from beginning to end of the phaseout is taxed at 190%.

The confiscatory nature of the tax is best illustrated by example: Assume A has a taxable estate of exactly $6.58 million. Taxpayer B has a taxable estate of $6.909 million. The estate of A would owe no tax, while the estate of B would owe estate tax of $626,352. After the payment of estate tax, the estate of B would have assets worth $6.283 million. Yet the estate of A would be worth $6.580 million, 4.7 percent more. The estate of A, which was worth $329,000 less than B, but incurred no estate tax, would end up with $297,352 more than the estate of B. This after B's payment of estate tax, calculated by imposing a 190 percent rate on the $329,000 difference between the size of the two estates.

The confiscatory nature of what occurs during the phaseout seems difficult to defend from a tax policy standpoint. The rapidity with which an estate incurs no estate tax to an estate that incurs an estate tax of $626,352 is only $329,000. It is puzzling why a taxable estate of $6.58 million would owe no tax, but a taxable estate worth only $20,000 more would owe $53,760.

New York Estate Tax

Taxable Estate	Estate Tax	Estate Tax Rate
↓ Exemption Shelters Tax ↓		
$6,580,000	0	0
↓ Rapid Exemption Phaseout Begins↓		
$6,600,000	$53,760	0.81%
$6,700,000	$352,480	5.26%
$6,800,000	$499,200	7.34%
$6,900,000	$619,692	8.98%
$6,909,000	**$626,352**	**9.07%**
↑Phaseout Complete at 5% > 6.58M↑		
↓ Rate of Tax Continues to Increase ↓		
$7,000,000	$638,000	9.11%
$7,251,000	$671,389	9.26%
$8M	$773,200	9.67%
$10M	$1,060,400	10.6%
$20M	$2,666,800	13.33%

II. Planning Overview

Planning in the federal gift and estate tax realm is less important today due to the $12.92 lifetime exemption. However, along with many other provisions of the 2017 Tax Act passed during the Trump Administration, the present gift and estate exemption amount is scheduled to "sunset" at the end of 2025. At that point, the federal exemption will revert to $5.3 million.

This factor complicates estate tax planning somewhat, because the planning must take into consideration whether the federal exemption amount becomes less than today. Making tax planning more complex is also the fact that the federal exemption is portable; any unused exemption at the death of the first spouse will be "ported" to the second spouse for his or her own use. However, New York does not recognize portability. Tax planning with divergent exemption amounts and differences in "porting" requires a coordination of federal and New York tax rules.

With respect to the porting issue, it may be undesirable to burden the estate of a surviving spouse of assets he or she might not need, since that might directly result in estate tax at confiscatory rates if within the 5 percent exemption phaseout window. However, it is also a truism that "the tax tail should not wag the dog." One might reasonably decide to burden the estate of a surviving spouse with assets that might later be taxed, if the assets would enhance the life or security of the surviving spouse.

III. Planning Strategies

New York estate tax liability can be reduced through various techniques, including gifting or consuming assets, employing formula clauses, utilizing valuation discounts, making charitable gifts or bequests, utilizing disclaimers, or establishing residency elsewhere. The taxpayer can entirely avoid the estate tax by relocating to a State without the tax, or can reduce or eliminate the tax by establishing residence in a State with a lower estate tax rate or a higher exemption amount. Most states today do not impose an estate tax.

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Lifetime Gifts

Gifts made during the donor's lifetime remove the asset from the taxable estate, with one catch: Under Tax Law §954(a)(3), gifts made within three years of death are "clawed back" into a New York resident's taxable estate. However, neither gifts of real or tangible personal property having a situs outside of New York at the time of the gift, nor gifts made at a time when the decedent was not a resident of New York, are subject to the rule. The clawback statute, which has been extended once, is now set to expire on January 1, 2026.

Credit Shelter Trusts

A credit shelter trust is usually a testamentary trust funded at death with an amount not exceeding the estate tax exemption. A surviving spouse is frequently named the lifetime beneficiary of the trust, with children being residuary beneficiaries. The estate of the taxpayer will not receive a deduction because the transfer is incomplete for gift and estate tax purposes. The exemption is utilized to avoid current tax liability.

Provided the rights of the spouse are limited, trust assets will not be included in the estate of the surviving spouse at her death. The ultimate beneficiaries will be named in the trust, and cannot be changed by the spouse without the beneficiaries' consent. The spouse may be given the right while living to all or a part of the trust income. Distributions of principal, if allowed by the trust, must be limited to those made for "health, education, maintenance and support" or a similar ascertainable standard. If the trust grants too many rights to the surviving spouse, the risk is that the assets will be included in the estate of the surviving spouse at his or her death.

Trust assets are provided a substantial degree of protection from claims of creditors. Such creditors could include the creditors of the surviving spouse, or later creditors of the children when they become beneficiaries. Considerable asset protection is provided discretionary rather than nondiscretionary distributions. If a beneficiary is entitled to all income, then less credit protection is provided. However, a clause in the trust providing for a suspension of distributions if a creditor issue arises might be of some deterrent effect.

In situations where the surviving spouse is intended to be the sole lifetime beneficiary, both a credit shelter trust and a marital deduction trust might be employed. The credit shelter trust would shelter the estate up to the exemption amount, and the marital deduction trust would provide the estate a deduction for the remainder.

Example

Taxpayer's taxable estate is now $6.8 million. Taxpayer does not wish to make an outright gift to an adult child, but does want to establish a trust for the child's benefit and for the ultimate benefit of his grandchildren. He funds a credit shelter trust with $300,000. His taxable estate is reduced to $6.5 million, $80,000 below the exemption amount. Provided taxpayer lives three years, and assuming the size of his taxable estate remains constant, his taxable estate will be below the estate tax threshold. If taxpayer were to pass within three years, trust assets would be "clawed back" into the estate, and estate tax liability of $499,200 would arise.

Use of a charitable gift hedge, discussed below, can lessen the effect of an untimely death within three years.

If the taxpayer does not wish to part with the funds now, the taxpayer could establish the same trust in will, making the bequest testamentary. If the taxpayer's estate were to remain constant, his estate would incur estate tax liability of $499,200. Note the identical tax liability would arise if the taxpayer's will simply bequeathed the amount funding the credit shelter trust outright instead. The use of the credit shelter trust does not provide a deduction to the estate. However, if the child's rights were limited, then trust assets would not be included in the child's estate when the child died.

Use of a charitable gift hedge, can also mitigate the effect of the estate tax if contained in a properly drafted testamentary instrument.

The principal advantage in making the gift to the trust now rather than making it at death lay in fact that New York does not tax lifetime gifts provided the taxpayer lives for three years after making the gift. If the taxpayer lives for three years after making the gift, the taxpayer will not deplete any part of his lifetime estate exemption by making the gift, and his taxable estate will be reduced by the size of the gift.

While it is true that the taxpayer will always have $300,000 less during his lifetime if he funds any trust (with respect to which he is not a beneficiary) by that amount, by so funding the trust during his life, estate tax savings may be disproportionate to the amount of the funds gifted to the trust. Many taxpayers will not part with a large sum of money which they might need in the future, even if it would operate to reduce estate taxes.

For large estates, the use of substantial lifetime gifts could result in significant tax savings, and are among the most simple tax planning techniques to employ. Nevertheless, many taxpayers contemplating making large gifts might be unwilling to accept the three-year waiting period.

Marital Deduction Trusts (QTIP)

Establishing a marital deduction trust for a surviving spouse will enable the taxpayer to utilize the available exemption on other testamentary transfers, since a testamentary bequest in the form of a qualifying trust to one's spouse qualifies for a complete marital deduction.

Such a "QTIP" trust must contain certain provisions which both limit surviving spouse's rights to trust property but also insure that the surviving spouse will be paid all of the income from the trust paid no less frequently than annually. In most cases, the trust will not provide for an invasion of principal for the benefit of the surviving spouse.

The QTIP trust is ideal in second marriage situations, since the taxpayer may wish to provide benefits to a second spouse, but may not want the

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spouse to determine the ultimate beneficiaries of the trust. Ultimate beneficiaries are determined by the taxpayer creating the trust; the surviving spouse has no power to alter the beneficiary designation.

[Since the QTIP trust does not satisfy the right of election in New York, a waiver by the beneficiary spouse would likely be required to prevent the spouse from electing against the QTIP in favor of an outright distribution, unless other assets left to the surviving spouse independently satisfied the spouse's statutory right to a percentage of the estate.]

The QTIP is useful where the entire exemption amount has already been applied by the taxpayer. Suppose that after gauging one's taxable estate, it appears that $250,000 will remain taxable after the exemption has been fully utilized. If the spouse is married, he or she can implement a marital deduction trust to dispose of the excess, even if the spouse has received some of the assets to which the exemption applied. The trust will provide a complete deduction to the decedent's estate, and will reduce the taxable estate perhaps to the threshold exemption amount, or below it. The surviving spouse must include the fair market value of appreciated trust assets in his or her estate at death (since the predeceasing spouse's estate received a deduction).

Note the difference in tax treatment compared to what occurs when the surviving spouse beneficiary of a credit shelter trust dies. In that case, no estate tax inclusion occurs because the gift to the trust was complete. Tax was avoided because of the exemption. With the QTIP trust, the gift is incomplete and a deduction is provided to the spouse creating the QTIP on condition that the surviving spouse include trust assets in his or her estate at death.

Disclaimers

A testamentary bequest can be disclaimed within nine months of death. When a bequest is disclaimed, it is treated for tax purposes as if the disclaimant predeceased the testator. A bequest may be disclaimed in whole or in part.

Assume taxpayer has a spouse and one child, and has a gross estate of $4 million. Taxpayer's will leaves a bequest of $3 million outright to his spouse, and $1 million outright to his child. This results in a taxable estate of $1 million, the spousal bequest qualifying for the full marital deduction.

Shortly after taxpayer's death, it appears that the taxable estate of the surviving spouse will exceed the sheltered exemption amount by about $1 million, which would subject the eventual estate to an estate tax of about 190%. Rather than accept the $3 million bequest, surviving spouse considers disclaiming $1 million, which would bring her taxable estate below the threshold at which New York estate tax would be imposed.

If spouse were to disclaim, taxpayer's taxable estate would be increased by $1 million due to the loss of the marital deduction, but would still be sheltered from New York estate tax by the available exemption. If surviving spouse is planning on making a bequest of her estate to the child, and determines that her assets are sufficient, then she might decide to disclaim. A disclaimer would result in neither the estate of the taxpayer nor that of the surviving spouse incurring New York State estate tax liability; both would be sheltered by the exemption.

In this case rather than disclaiming, the surviving spouse could simply make a $1 million gift to her child, which would also reduce the size of her estate below the estate tax threshold. However, there is always the risk that the surviving spouse would die within 3 years, voiding the gift and subjecting the estate to estate tax substantially exceeding the amount of the failed gift.

Valuation Discounts

When property is placed in corporate, partnership, or LLC form, a partial ownership interest has fewer rights than outright ownership. This reduces the value of a partial ownership interest. Valuation discounts are most commonly applied to interests in real estate or closely held family businesses. If the owner of real estate creates a partnership or LLC, and retains most of the interest, but gifts or sells a fractional interest to a third person, the value of what the owner has retained may be entitled to a discount attributable to various limitations inherent in the partnership or LLC form. These include discounts for lack of marketability, lack of control, and a minority interest discount. Valuation discounts of 20 percent for partial interests in real estate or a closely held business are not uncommon.

Charitable Bequests

A charitable bequest may be useful in negotiating the exemption "cliff." If a will provision states that assets in excess of the exemption amount will fund a charity, New York estate tax may be reduced or avoided. However, there are dangers to using this type of formula provision. Gifts to a charity invoke the involvement of the New York Attorney General. Disputes involving formula clauses could arise over what amount needs to be given to the charity. Unwanted administrative issues may also arise. Involvement with Attorney General's office to reduce estate taxes seems like an undesirable tradeoff. If one is charitably inclined, then an outright gift of a sum certain, which will accomplish approximately the same purpose, seems preferable.

Charitable Gift Hedging

The three year "clawback" rule for gifts will soon expire. It may or may not be extended. One option for insuring that the estate will benefit would be to make a conditional charitable bequest, dependent upon the status of the clawback rule. If the clawback statute expires then the conditional charitable bequest would expire with it due to the failure of a condition precedent. If the clawback were extended, and decedent died within three years of the gift, then the charitable gift of an amount necessary to provide a deduction to eliminate the estate tax would be made. This would prevent the excess over the allowable exemption amount to be taxed at rates of up to 190%.

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Establishing Legal Residence in Another State

Jurisdictions that impose an estate tax are concentrated in the northeast and in the far west. Every state in New England except New Hampshire has an estate tax. (Connecticut has a \$9.1 million exemption and a flat tax rate of 10.8% to 12%; whereas Massachusetts has an exemption of \$1 million, with rates ranging from 0.8% to 16%.)

Among mid-Atlantic States, New York has an estate tax, while New Jersey and Pennsylvania assess an inheritance tax but no estate tax. Delaware also has no estate tax. No state south of Delaware and east of the Mississippi has an estate tax, except Maryland, the District of Columbia, and Illinois. Minnesota, Washington, Oregon and Hawaii comprise the remaining states with an estate tax.

For those considering relocating, the best plan would be to go south or west — even to California. Jurisdictions having no estate tax include, but are not limited to Arizona, California, Colorado, Florida, Georgia, Nevada, New Hampshire, New Mexico, South Carolina, Tennessee, Texas, Utah, Virginia, and West Virginia.

Changing one's residence to another state, if successfully established, will result in the taxpayer no longer being subject to New York estate tax. However, a change of residence is less effective if one's family still resides in New York and one makes frequent trips to New York, or if one wishes to visit New York frequently, or if one makes frequent business trips to New York. Retaining a physical place to reside while visiting New York makes renouncing one's new York residence nearly impossible.

The residency rules are complex and the Department of Taxation takes aggressive positions. Disputes with the Department not settled in audit are reviewable by the Division of Taxation, an administrative tribunal. Adverse determinations are appealable to the Tax Appeals Tribunal and then to the Appellate Division, Second Department, in Albany.

If one plans to leave New York, the fewer contacts maintained with New York, the less likely the Department of Taxation will audit, and the less likely the taxpayer will end up receiving letter "determining" that the taxpayer owes tax, interest, and penalties. The most propitious time to resolve the dispute may be at the audit stage. The auditor may want to get the file off his or her desk, and be credited with closing the case. Even in situations where the taxpayer's position has some merit, all but the most meritorious cases seem to be winnowed out in litigation. Resort to tax litigation in New York's administrative tax tribunals, from a purely statistical standpoint, seldom bears fruit.

IV. Conclusion

Many strategies can reduce or eliminate the incidence of estate tax, whether the estate is within the exemption phaseout spectrum, or beyond it. The "cliff" feature of the tax is truly a trap for the unwary. Even a modest amount of estate planning can prove extremely effective in blunting the confiscatory rate of tax imposed on taxable estates between \$6.58 and \$6.91 million; and the nonconfiscatory, but nevertheless high tax rates imposed estates greater than \$6.91 million.

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als, with several modifications. The Medicare or Net Investment Income Tax (NIIT), a 3.8 percent surtax on unearned income, applies to nongrantor trusts subject to Subchapter J. IRC §1411.

The tax is 3.8 percent of the lesser of (i) undistributed net investment income or (ii) the excess (if any) of (a) AGI over (b) the dollar amount at which the highest tax bracket in IRC §1(e) begins for the tax year. Since the highest tax bracket for trusts (and estates) begins at $14,450, and since trusts may not operate as a business, most undistributed trust income could be subject to the tax at 40.8 percent. This makes accumulation of trust income undesirable.

As is true with individuals, nongrantor trusts are entitled to deduct expenses and are allowed a personal exemption. They may also deduct amounts distributed to beneficiaries, subject to an important proviso: The ceiling on the deduction is limited to the *distributable net income* (DNI) of the trust. The theme of fiduciary income taxation is to tax the beneficiary receiving the current benefit. To a significant degree, the trust instrument and local law may affect the determination of who is taxed.

Trusts are subject to the AMT. For tax years beginning in 2022, trusts and estates are entitled to a $26,500 exemption in determining the amount of income to which the AMT applies. IRC §55(d)(1)(D); Rev. Proc. 2021-45. For individuals, estates and trusts, a graduated two-tier AMT rate schedule applies.

The fiduciary income tax rules apply only to entities *classified* as trusts for federal income tax purposes. A trust is an arrangement to protect or conserve property for the benefit of beneficiaries. An entity nominally ascribed trust status may be recharacterized as a corporation or partnership for federal income tax purposes if the entity carries on a business for profit. IRC §7701(a)(3).

Simple Versus Complex Trusts

Under Subchapter J, all nongrantor trusts are either "simple" or "complex" trusts. A simple trust is one which (i) requires all income to be distributed at least annually (whether or not income is actually distributed); (ii) makes no distributions of principal (whether or not the trust instrument permits); and (iii) must not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes. IRC §651(a)(2). If the trust is a simple trust, all income will be "carried out" to beneficiaries and the trust will take a distribution deduction for that amount. The character of the amount distributed will be passed through to the beneficiary. Simple trusts are allowed a $300 personal deduction. IRC §642(b).

Although defined by the trust instrument, a trust will not be considered a simple trust if the trust definition of income conflicts with that under local law. Thus, if the trust instrument provides that income includes all capital gains, it is doubtful that such trust would qualify as a simple trust for federal income tax purposes even if the trust required all income to be distributed annually. Also, despite the fact that a trust may require income to be distributed, a trustee, for whatever reason, may not make a distribution of income. This would also cause the trust not to be a simple trust in that tax year.

All trusts that are not simple trusts are complex trusts. A complex trust is one in which either (i) all income is not required to be distributed annually or (ii) distributions of principal are made in the taxable year. A simple trust might become a taxable trust if the trust in a given taxable year provides for discretionary distributions of principal, and a principal distribution is made in a particular year. Similarly, a trust may in fact distribute all income yet not be a simple trust because the instrument does not require it. Complex trusts are allowed a personal exemption of $100. IRC §642 (b).

II. Distributable Net Income (DNI)

For income tax purposes, trusts are considered "modified" tax conduits, since some trust income is reported by beneficiaries, and some by the trust itself. Distributions to beneficiaries are in part taxable, and in part tax-free. Distributions may be tax-free to beneficiaries either because (i) they derive from tax exempt income, (ii) they constitute distributions of principal, or (iii) they constitute distributions of accumulated income, with respect to which the trust has already paid tax in a previous tax year.

If income is taxable, then either the trust or beneficiary will pay tax. If the beneficiary is required to pay tax on a distribution, the trust will receive a corresponding distribution deduction. If the distribution is tax free to the beneficiary, the trust will be not receive a deduction. The tax concept utilized to determine that portion of a distribution which is taxable to the beneficiary and deductible to the trust is the distributable net income (DNI) of the trust. Neither the distribution deduction to the trust, nor the income reportable by the beneficiary receiving a distribution, may exceed DNI.

Gross income of a trust is generally calculated as it would be for an individual. The following items are therefore excluded from gross income of a trust: (i) property acquired by gift; (ii) life insurance proceeds; and (iii) tax-exempt interest.

DNI is determined by making several adjustments to "tentative" taxable income. To arrive at tentative taxable income, deductions from gross income are taken. Those deductions track (with some minor variations) deductions available to individuals).

DNI equals tentative taxable income increased by (i) the personal exemption and (ii) tax-exempt interest; and decreased by (iii) capital gains and (iv) extraordinary dividends. DNI will determine both the amount of income reported by a beneficiary as well as the character of that income. To the extent the beneficiary receives a distribution in excess of DNI, that amount will be nontaxable to the beneficiary and nondeductible by the trust.

The beneficiary generally takes a substituted basis in distributed property, and tacks the holding period of the trust. However, the trustee may elect to recognize gains or losses on the distribution of appreciated property. This may be prudent if the trust has losses which can offset gains. If this election is made, the beneficiary will take a fair market value basis in the

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distributed property, and a new holding period will commence.

Example: Trust has income of $40,000, $10,000 of which is interest income, and $30,000 of which is dividends. Fees are $3,000. Trust has capital gains of $15,000. An exemption of $300 is available.

Calculation of Gross Income:

Interest Income	$10,000
Dividends	$30,000
Capital Gains	$15,000
Gross Income	$55,000

Calculation of Taxable Income:

Gross Income	$55,000
Exemption	($300)
Fees	($3,000)
Taxable Income	$51,700

Calculation of DNI:

Taxable Income	$51,700
Exemption	$300
Capital Gains	($15,000)
DNI	$37,000

Trust beneficiaries must report all income distributed (or required to be distributed) to them to the extent of DNI. As is the case with S corporations and partnerships, the trust is a "conduit" for purposes of determining the character of income. Items of income retain their character when distributed. However, unlike single-member LLCs and grantor trusts, nongrantor trusts are not disregarded entities for income tax purposes. The determination of whether a trust is a grantor or nongrantor trust is consequently crucial.

It is entirely conceivable that a trust could be a nongrantor trust in one taxable year and a grantor trust in a subsequent taxable year. This could occur if the trustee were granted the power to "toggle" the trust by activating a provision in the trust which would cause the nongrantor trust to be a grantor trust. One such provision often used to accomplish this would be to allow the trustee the power to substitute property of equal value. IRC §675.

With respect to simple trusts, unless the trust instrument provides otherwise, all beneficiaries share in income, and in the tax items, on a pro rata basis. If the trust has tax exempt and taxable income, the beneficiaries will report the taxable and tax exempt income in proportion to their share of income. The trust instrument may validly alter this result by providing that one beneficiary share disproportionately in tax exempt or taxable income. However, it is not enough that the trust instrument grants the trustee discretion in this regard.

Expenses allocable to separate items of DNI (with differing character) may produce multiple netted DNI items. Tax-exempt interest must be allocated a pro rata amount of expenses. Some expenses cannot be traced to individual DNI items. In those cases, the trustee may allocate expenses to DNI items taxed at higher rates. Notwithstanding the above, the actual source of payment is not traced.

The distribution deduction is the lesser of (i) "modified" DNI and (ii) the amount actually distributed or required to be distributed. Modified DNI is DNI reduced by the tax-exempt portion of DNI. Some distributions do not "carry out" DNI. Such distributions are tax free to beneficiaries and nondeductible to the trust. For example, a specific bequest not carrying out DNI will be nontaxable to the beneficiary and nondeductible to the trust or estate.

Prior to the relative parity between the tax rates imposed on trusts and individuals, accumulations of income were viewed as abusive, since trusts were taxed at lower rates. The "throwback" rules were enacted to stem this perceived abuse. Today, throwback no longer applies to domestic trusts, principally because nongrantor trusts are taxed at rates that exceed those imposed on individuals. However, throwback still applies to foreign trusts. Accumulated income (on which tax has been paid by the trust) becomes part of corpus, unless the trust instrument provides otherwise. Distributions in excess of current income are distributions of principal which are tax-free to the beneficiary.

III. Specific Bequests

A will may make a specific bequest to a beneficiary. Technical rules apply to determine whether the bequest is taxable to the beneficiary. To avoid carrying out DNI to a beneficiary, the specific bequest must (i) be in fewer than four installments; (ii) not be payable from income and (iii) must be "ascertainable" as of the inception of the trust or estate. This rule is significant, since post-death appreciation will not be taxed to a beneficiary receiving a qualifying bequest. Rather, residuary beneficiaries – who are considered to take title to estate assets by operation of law at the death of the decedent – will be charged with reporting income attributable to post-death appreciation. IRC § 663; Treas. Regs. §1.663(a)-1.

Note that if the specific bequest were of income producing assets, although the beneficiary would not be charged with income under Subchapter J by reason of DNI being carried out, the beneficiary would nevertheless report income from post-death appreciation under normal income tax rules.

To satisfy the requirement that the specific sum of money or other property be "ascertainable," the regulations provide that the legacy of money or the bequest of specific property must be ascertainable under the terms of the will or governing instrument at the time of the decedent's death. It is the view of the IRS that formula bequests generally will not be ascertainable because they cannot be determined at the time of the decedent's death.

IV. Fiduciary Accounting Income

Fiduciary accounting income (FAI) is income available for payment only to trust income beneficiaries. It includes dividends, interest, and ordinary income. Principal and capital gains are generally reserved for distribution to remainder beneficiaries. The trust may define trust accounting income to include capital gains.

Distributions of fiduciary accounting income from both simple and complex trusts will be taxable to the beneficiary to the extent of the lesser of the amount distributed or DNI, and

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deductible to the trust in the identical amount. Amounts distributed in excess of DNI will not be taxable to the beneficiary, but neither will the trust receive a deduction. IRC §§ 651(a); 661 (a)(1). Distributions made to multiple beneficiaries will be reported by beneficiaries according to the proportion of the total DNI that each beneficiary receives. IRC §§ 652(b)(c); 662(b)(c).

Provided that no more than the total amount of "fiduciary accounting income" is distributed, the trust may qualify as a simple trust. In reaching this limit, it is immaterial that items constituting trust corpus on the trust ledger are actually distributed. Thus, the distribution of $10,000 by a trust with fiduciary accounting income of $10,000 whose source is from corpus will nevertheless be treated as a distribution of fiduciary accounting income, since the required income distribution may be satisfied by a distribution of corpus.

Trust principal consists of assets of the trust which are being held for eventual distribution to the remainder beneficiaries. Income consists of the return in cash or property from the use of principal. Rental property would thus be considered trust principal, and the income it generates would be considered trust income. If sold, the proceeds would remain trust principal. Trust principal may be considered the "tree" and trust income the "fruit" of the tree.

If income is accumulated and used to purchase other assets, those assets remain income assets. For example, trustee accumulates $50,000 of income in 2023 and purchases a CD. Interest from the CD is income, but so is the CD itself. Although the trust may contain other CDs that constitute corpus, this $50,000 CD would retain its character as an income asset, rather than a principal asset. Thus, a trustee under a HEMS standard with respect to income distributions could properly distribute the $50,000 to income beneficiaries when the CD matures.

The term "income," when not modified by the words "taxable," "distributable net," "undistributed net," or "gross" in Subchapter J means the amount of income determined under the trust instrument or local law. Thus, as used in Subchapter J, *fiduciary accounting income* is not a tax term. The Code has some bearing on fiduciary accounting income, since unrealistic definitions of fiduciary accounting income will affect federal income tax. When that occurs, the Regulations may intercede. Fiduciary accounting income includes some items that are not included in gross income and excludes other items that are included in gross income. For example, fiduciary accounting income includes tax-exempt interest, an item excluded from gross income, but excludes capital gains, an item included in gross income.

In general, principal includes capital gains and sales of property, casualty losses, stock dividends, and a portion of trustee commissions and investment fees. Fiduciary accounting income includes dividends, net rental income from real or personal property, interest, dividends, and a portion of trustee commissions and investment fees.

V. Tier Rules for DNI

The tier rules affect the allocation of distributions among beneficiaries where distributions from a complex trust exceed DNI. IRC §662(a)(2). Some beneficiaries may be nondiscretionary distributes entitled to trust accounting income, while other beneficiaries may be discretionary distributes. The tier rules are intended to ensure that nondiscretionary distributees entitled to accounting income are taxed, while discretionary distributees are not taxed. Nondiscretionary distributees are characterized as "first tier" distributees, while discretionary distributees are "second tier" distributees. If allocations are not contained in the trust instrument, the Uniform Principal and Income Act (UPIA) adopted by New York and 38 other states will govern the allocation.

The tier system of allocating DNI is applicable if (i) distributions exceed DNI; (ii) there are multiple beneficiaries; (iii) some beneficiaries are required to receive trust accounting income (first tier beneficiaries); and (iv) other beneficiaries may receive discretionary distributions. Under the general rule which requires proration, the result would not be in accord with the tier rules.

Under the tiering rules, first tier beneficiaries will be allocated DNI first. Any remaining DNI will then be allocated to second tier beneficiaries. Where DNI exceeds first tier distributions, each beneficiary is taxed on a proportionate share of distributions. For example, if DNI = 10, and 4 is distributed to each of A and B, then A and B would report ½ x 8 of income. DNI is the ceiling, but not the floor, in determining taxation. Since A and B were distributed only 4, they are taxed on only that amount.

DNI is allocated among tier one beneficiaries in proportion to their respective fiduciary accounting income. Residual DNI is then allocated among tier two beneficiaries *pro rata*. Once DNI is exhausted, any remaining amounts distributed are deemed distributions of corpus, and are distributed tax-free to beneficiaries.

If first-tier distributions exceed DNI, each beneficiary reports a pro rata share of DNI. After DNI is exhausted, remaining distributions are tax-free. For example, if DNI = 10, and 6 is distributed to each of A and B, then A and B would report ½ x 10 of income. Since DNI is the ceiling on tax, A and B would receive 1 each tax-free.

Illustration. Trust provides that all income is to be distributed to beneficiary 1 and that the trustee may make discretionary distributions to beneficiary 2. In a year in which trust has fiduciary accounting income and DNI of $100,000, trustee distributes $100,000 to beneficiary 1 and $10,000 to beneficiary 2. Under the tier rules, beneficiary 1 is allocated all of the DNI and beneficiary 2 is allocated none. Beneficiary 1 is taxed on $100,000 and beneficiary 2 receives the $10,000 as a tax-free distribution of corpus.

VI. Allocation of Trust Expenses

The Regulations stipulate that expenses directly attributable to a specific class of income are allocated to that income. Expenses not capable of being allocated to a specific class of income may be allocated in the discretion of the fiduciary to one or more

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classes of income. However, indirect expenses must be allocated between taxable and tax-exempt income. Trustee commissions in general would be equally allocated to income and principal, since they appear not to be directly related to a specific class of income. Expenses incurred with respect to real estate activities, on the other hand, would constitute expenses that could be deducted from real estate income, as they appear to be directly related to real estate activity.

In arriving at fiduciary accounting income, expenses attributable to that income are allowed. Expenses of administration and trustee commissions are apportioned between income and principal in accordance with the trust instrument or if not, in accordance with local law. The standard against which the determination of whether all income has been distributed refers to fiduciary accounting income. Whether or not the trustee has distributed all taxable income or all distributable net income of the trust is immaterial.

An allocation to principal will benefit remainder beneficiaries, while an allocation to income will benefit current income beneficiaries. Historically, most trusts have not permitted the allocation of capital gain to income since doing was thought to be unfair to remainder beneficiaries. However, it is now thought to be prudent to permit allocating some capital gain to income beneficiaries to permit the trust to have a higher total return. A higher total return benefits both income and remainder beneficiaries.

Therefore, an allocation of capital gain to DNI will be respected provided (i) the allocation to fiduciary accounting income is made pursuant to a dictate under the governing instrument and local law; or (ii) the allocation is made pursuant to trustee discretion under local law or the governing instrument. However, if the allocation is pursuant to trustee discretion, that discretion must be exercised reasonably and impartially and must not conflict with local law.

In general, and subject to an unlikely election by the trustee to report on the accrual method of accounting, most trusts will report on a cash basis. This will generally be beneficial, as it will result in a deferral of income, and will also permit the trustee to time distributions to make the most effective use of deductions. For taxable years after 1986, trusts are required to report on a calendar year basis. Trusts are also required to make estimated tax payments. IRC §643(g)(1)(A) authorizes the trustee to elect to treat any portion of an estimated tax payment as being made by a beneficiary. As noted, trusts are subject to the AMT.

IRC §67(a) provides that miscellaneous itemized deductions are allowed only to the extent that those deductions exceed two percent of AGI. IRC §67(e) provides that AGI of an estate or trust is computed like that of an individual, except that costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in such estate or trust are allowable in arriving at AGI. Consequently, those costs are not subject to the two percent floor.

The Supreme Court in *Knight v. Com'r*, 552 U.S. 181 (2008) held that fees customarily or generally incurred by an estate or trust are not uncommonly incurred by individual investors. Therefore such expenses are subject to the two percent floor. The Court acknowledged it was conceivable "that a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various parties, such that a reasonable comparison with individual investors would be improper."

Taking its cue from *Knight*, Treasury withdrew earlier proposed regulations, and advanced new proposed regulations. Under new proposed regulations, to avoid the two-percent floor, the trust or estate must show that (i) the investment advisory fee exceeds that normally charged to individual investors; and (ii) the excess is attributable to an unusual investment objective of the trust or estate.

Distributions of appreciated property in kind in satisfaction of the obligation of the trustee to distribute income will result in recognition of gain or loss to the trust or estate. DNI will be carried out to the extent of the fair market value of the property. Basis of the property will be adjusted to reflect gain or loss. Treas. Reg. §§ 1.651(a)-2(d) and 1.661(a)-2(f); Rev. Rul. 67-74. If a trustee or executor distributes appreciated property but not in satisfaction of an obligation, DNI is carried out to the extent of the lesser of basis or the fair market value of the asset. Alternatively, the trustee or executor may elect to treat the distribution as if the distribution were made in satisfaction of an obligation, as described above, with the executor or trustee recognizing gain or loss, and basis being adjusted accordingly.

The trustee of a "qualified" revocable (grantor) trust may elect to treat the trust as part of the grantor's estate for federal income tax purposes. The election will among other things give the executor more flexibility in choosing the fiscal year of the trust, and will provide some relief for trusts which holds S corporation stock. The election once made is irrevocable, and must be made on the first timely filed income tax return of the estate.

Since the beneficiary will be taxed on distributions required to be made, distributions made after the taxable year, but reported in the earlier taxable year, do not impair the fisc. Consequently, under the 65-day rule, the trustee (or executor) may elect to treat distributions made within the first 65 days of a taxable year as having been made on the last day of the previous year. DNI will be deemed to have been carried out on the last day of the previous taxable year. The election is made on the fiduciary tax return. By utilizing the 65-day rule, the trust has some flexibility in determining it taxable income. Since trust tax rates are compressed, it may be possible to distribute enough to fall into a lower tax bracket.

Upon termination, a trust must distribute all income and principal to beneficiaries. By definition, all trusts will be complex trusts in the year of trust termination. Any operating losses which the trust has in the year of termination will pass through to the beneficiaries, who may deduct such losses as itemized deductions. Capital loss carryovers may also be utilized by trust beneficiaries in the final year of the trust.

Under the separate share rule, a

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trust may be divided for tax purposes into separate trusts where the trust provides for separate shares, or where the trust or local law require separate shares by reason of trust distributions or provisions of the trust appearing to require that result. If the separate share rule applies, the trust will be treated for tax purposes as separate trusts for purposes of carrying out distributable net income. For the separate share rule to apply, the division of the trust into multiple shares must not affect the rights of other beneficiaries. The separate share rule does not increase the number of personal exemptions available to the trust.

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tion of personal property. Today, that distinction has vanished.

The will operates on the estate of the decedent, determining the disposition of all probate assets. However, its sphere of influence does not end there: Under NY Estates, Powers and Trusts law (EPTL), the will can dictate how estate tax is imposed on persons receiving both probate and nonprobate assets. Probate assets are those assets capable of being disposed of by will. Not all assets are capable of being disposed of by will. For example, a devise of the Adirondack Northway to one's heirs — although a nice gesture — would be ineffective. Similarly, one cannot dispose by will of assets held in joint tenancy, such as a jointly held bank account or real property held in joint tenancy, since those assets pass by operation of law, regardless of what a contrary (or even identical) will provision might direct.

So too, a life insurance policy which designates beneficiaries other than the estate on the face of the policy would trump a conflicting will designation. However, litigation could ensue, especially if the conflicting will provision appeared in a will executed after the beneficiary designation was made in the insurance policy. The reason for the insurance policy prevailing over the will designation is not altogether different from the situation involving the Northway: The insurance company will have been under a contractual obligation to pay the beneficiaries. That obligation arguably cannot be affected by a conflicting will provision since this would cause the insurance company to breach its obligations to the named beneficiaries under the life insurance contract, just as the transfer by Albany to the decedent's beneficiaries of title to the Northway would breach the obligation of New York to retain title over the public thoroughfare.

Note that the decedent could properly dispose of the insurance policy by will if the life insurance policy instead named the estate of the decedent as the sole beneficiary. In fact, in that case, only the will could dispose of the insurance contract. If there were no will, the contract proceeds would pass by intestacy to the decedent's heirs at law. If the testator has a good idea to whom he wishes the proceeds of the policy to pass following his death, it is generally a poor idea to own the policy outright, regardless of whether the proceeds of the policy are paid to the estate of the decedent or to beneficiaries named in the policy. This is so because if the decedent owns the policy, the asset will be included in his gross estate, and therefore will be subject to federal and New York estate tax. This result also illustrates the concept that the gross estate for federal and NYS estate tax purposes includes both probate and nonprobate property.

By virtue of transferring the policy into an irrevocable life insurance trust, the testator could avoid this potential estate tax problem. If the testator is planning to purchase a new policy, the trustee of a new or existing trust should purchase the policy. If the testator wishes to transfer an existing policy to a trust, the Internal Revenue Code (which New York Tax Law follows) provides that he must live for three years following the transfer for the policy to be excluded from his gross estate. If the decedent is not sure to whom he wishes to leave the insurance policy, creating an irrevocable life insurance trust to own the policy may not be a good idea, since the beneficiary designation will be irrevocable. However, if the testator knows to whom he wishes the policy benefits to pass, an irrevocable trust may reduce estate tax. The insurance policy will also have greater asset protection value if placed in trust. Finally, the proceeds of the life insurance policy held in trust could be used by beneficiaries to pay estate taxes. This can be helpful if the estate is illiquid.

II. Formalities of Execution

A will may be executed by any person over the age of majority and of sound mind. The Statute of Frauds (1677) first addressed the formalities of will execution. Until then, the writing of another person, even in simple notes, constituted a valid will if published (orally acknowledged) by the testator. The statute required all devises (bequests of real property) to be in writing, to be signed by the testator or by some person for him in his presence and by his direction, and to be subscribed to by at least three credible witnesses. The rules governing the execution of wills in New York and most other states (except Louisiana, which has adopted the civil law) have remained fairly uniform over the centuries. The common law rules of England have since been codified in the States. In New York, these statutory rules are found in the EPTL ("Estates, Powers and Trust Law").

For a will to be valid, EPTL §3-2.1 provides that the testator must (i) "publish" the will by declaring it to be so and at the same time be aware of the significance of the event; (ii) demonstrate that he is of sound mind, knows the nature of his estate and the natural objects of his bounty; (iii) dispose of his property to named beneficiaries freely and willingly; and (iv) sign and date the will at the end in the presence of two disinterested witnesses. While the execution of a will need not be presided over by an attorney, case law provides that where an attorney does preside over execution, there is a presumption that will formalities have been observed. The execution of a "self proving" affidavit by the attesting witnesses dispenses with the need of contacting those witnesses when the will is later sought to be admitted to probate.

A will should be witnessed by two disinterested persons. A will witnessed by two persons, one of whom is interested, will be admissible into probate. However, the interested witness will receive the lesser of the amount provided in the will or the intestate amount. A corollary of this rule is that anyone who receives less under the will than under intestacy would suffer a detriment by being the only other witness. In general, it is not a good idea for an interested person to witness a will, although there are of course times when this admonition cannot be heeded. The rule is less harsh if the execution of the will is witnessed by two disinterested witnesses in addition to the interested witness. In this case, the interested witness is permitted to take whatever is bequeathed to him under the will, even if this amount is more than he would have received by intestacy.

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III. Rights of Heirs

Following the testator's death, the original will may be "propounded" to the Surrogate's Court for probate. For a propounded will to be admitted, the Surrogate must determine whether the will was executed in accordance with the formalities prescribed in the EPTL. If the decedent dies intestate (without a will) the estate will still need to be administered in order to dispose of the estate to "distributees." The term distributee is a term of art which defines those persons who take under the laws of descent in New York. A beneficiary under the will may or may not be a distributee, and vice versa. All distributees, whether or not provided for in the will, have the right to appear before the Surrogate and challenge the admission of the will into probate. Thus, even distant heirs may have a voice in whether the will should be admitted to probate. Distributees may waive their right to appear before the Surrogate by executing a waiver of citation. A distributee waiving citation is in effect consenting to probate of the will. Distributees, either when asked to sign the waiver, or when being served with a Citation, will be provided with a true copy of the will.

If a distributee does not execute a waiver, he must be served with a citation to appear before the Surrogate where he may challenge the admission of the will into probate. Since a distributee having a close relation to the decedent would be the natural objects of the decedent's bounty, the disinheritance of a closely related distributee would have a higher probability of being challenged than would the disinheritance of a distant heir. Persons taking under the will who are not distributees are also required to be made aware that admission of the will into probate is being sought. Those persons would receive a Notice of Probate, but would have no statutory right to receive a citation. A Notice of Probate is not required to be sent to a distributee. Any person in physical possession of the will may propound it for probate. Not propounding the will with respect to which one is in physical possession works to defeat the decedent's testamentary intent. Accordingly, legal proceedings could be brought by distributees (those who would take under the laws of intestacy) or other interested persons to force one in possession of the will to produce a copy of the will and to propound the will for probate. It appears that an attorney in possession of the original will is under an ethical, if not a legal, duty to propound the will into probate. The NYS Bar Ethics Committee observed that an attorney who retains an original will and learns of the client's death has an ethical obligation to carry out his client's wishes, and quite possibly a "legal obligation…to notify the executor or the beneficiaries under the will or any other person that may propound the will…that the lawyer has it in his possession." N.Y. State 521 (1980).

IV. Importance of Domicile

A will of a decedent living in New York may only be probated in the county in which the decedent was "domiciled" at the date of death. The traditional test of domicile is well established. "Domicile is the place where one has a permanent establishment and true home." J. Story, Commentaries on the Conflict of Laws § 41 (8th ed. 1883). Therefore, the will of a decedent who was a patient at NYU Medical Center for a few weeks before death but was living in Queens before his last illness would be probated in Queens County Surrogate's Court. The issue of domicile has other important ramifications. For example, while New York imposes an estate tax, Florida does not. In addition, "ancillary" probate may be required to dispose of real property held by a New York domiciliary in another state. For this reason, it is sometimes preferable to create a revocable inter vivos trust to hold real property that would otherwise require probate in another jurisdiction. Converting real property to personal property by deeding it into a limited liability company might also provide a solution, since personal property (in contrast to real property) may be disposed of by will in the jurisdiction in which the will is probated.

V. Admission to Probate

If no objections are filed, and unless the instrument is legally defective, the original instrument will be "admitted" to probate. In practice, clerks in the probate department make important decisions affecting the admission of the will into probate. For this reason, among a legion of others, probating of wills of decedents by persons other than attorneys is ill-advised. Following the admission of the will into probate, the Surrogate will issue "Letters Testamentary" to the named Executor to marshal and dispose of assets passing under the will. If the will contains a testamentary trust, "Letters of Trusteeship" will be issued to named Trustees under the will. Letters Testamentary and Letters of Trusteeship are letters bearing the seal of the Surrogate which grant the fiduciary the power to engage in transactions involving estate assets.

VI. Executors and Trustees

The Executor and Trustee are fiduciaries named in the will whose duty is to faithfully administer the will or testamentary trust. The fiduciary is held to a high degree of trust and confidence. In fact, a fiduciary may be surcharged by the Surrogate if the fiduciary fails to properly fulfill his duties. In most cases, there will be only one Executor, but occasionally a co-Executor may be named. The will may also contain a designation of a successor Executor and the procedure by which a successor Executor may be chosen if none is named. A mechanism by which an acting Executor may be replaced if unable to continue serving, or may depart, if he so wishes, would also likely be addressed in the appropriate will clause. Even in cases of intestacy, a bank, for example, will require proof of authority to engage in transactions involving the decedent's accounts. The Surrogate will issue "Letters of Administration" to the Administrator of the estate of a decedent who dies intestate. An Administrator is a fiduciary of the estate, as is the Executor or Trustee.

A trustee designation will be

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made for trusts created in the will. In some cases, the Executor may also be named a Trustee of a testamentary trust, but the roles these fiduciaries play are quite different, and there may be compelling reasons for not naming the Executor as Trustee. For example, the Executor may be older, and the beneficiaries may be quite young. Here, it may be desirable to name a younger Trustee. The decedent might even wish that the Trustee be the parent. Multiple trustees may also be named. A corporate or professional Trustee may be named to assist in managing Trust assets. One should be aware that trusts and trustees often form symbiotic relationships, and the costs of naming a corporate or professional Trustee should be carefully evaluated. Like the executor, a trustee is also a fiduciary. One important rule to remember when naming a trustee is that under the EPTL, a trustee may not participate in discretionary decisions regarding distributions to himself. Thus, if a sole trustee were also the beneficiary of a testamentary trust, another trustee would need to be appointed to decide the extent of discretionary distributions to be made to him. *See* EPTL 7-A-8.14.

The rule is actually a constructive one, in that it prevents deleterious estate tax consequences under IRC §2036. The rule is also helpful from an asset protection standpoint, since a beneficiary who is also trustee could be required to make distributions to satisfy the claims of creditors. If the trust is a discretionary trust in which the beneficiary has no power to compel distributions, the trustee could withhold discretionary distributions under the creditor threat disappeared.

VII. Avoidance of Intestacy

Unless all or most assets of the decedent have been designed to pass by operation of law, intestacy is generally to be avoided, for several reasons: First, the decedent's wishes as to who will receive his estate is unlikely to coincide with the disposition provided for in the laws of descent. Second, the will often dispenses with the necessity of the Executor providing bond. The bond required by the Surrogate may constitute an economic hardship to the estate if the estate is illiquid. If there is no will, there will be no mechanism by which the decedent may dispense with the requirement of furnishing bond. Third, a surviving spouse has a right to inherit one-third of the decedent's estate. If the will leaves her less, she may "elect" against it and take one-third of the "net estate."" However, if the decedent dies intestate, the surviving spouse has greater rights: Under the laws of descent in New York, a spouse has a right to one-half of the estate, plus $50,000, assuming children survive. If there are no children, the surviving spouse is entitled to the entire estate.

In the event no administrator emerges from among the decedent's heirs at law, a public administrator will need to be appointed. Disputes among heirs at law may arise as to who should serve as Administrator. If there are six heirs at law with equal rights to serve as Administrator, it is possible that the Surrogate would be required to issue Letters of Administration to six different people. What a will may provide is limited only by the imagination of the testator and the skill of the attorney. This is also why it is imperative to have a will in place even where the rules of descent (intestacy) are generally consistent with the decedent's testamentary scheme.

VIII. Lost, Destroyed & Revoked Wills

When executing a will, the testator is asked to initial each page. Paragraphs naturally ending on one page are sometimes intentionally carried over to another page to thwart tampering by improper insertion of a substitute page. If the original will has been lost, a procedure exists for the admission of a photocopy, but the procedure is difficult and its outcome uncertain. Removing staples from the will to copy or scan it is a poor idea. To a degree not required of most other legal instruments, the bona fides of a will is dependent upon a finding that its physical integrity is unimpeachable, meaning that the will is intact and undamaged. A will that has been damaged (e.g., staples removed for photocopying) may be admissible, though not without considerable difficulty. While the Nassau County Surrogate has accepted wills whose staples have been removed without undue difficulty, some New York Surrogates take a dim view of wills that are not intact. If the original will cannot be located and was last in the possession of the decedent, there is a presumption that the will was revoked. The reasoning is that in such cases it is likely that the decedent intentionally destroyed the will, thereby revoking it.

Revocation will also occur if the will has been mutilated. In some jurisdictions, if provisions of the will have been crossed out, the will be deemed to have been revoked. In other jurisdictions, crossing out provisions will not invalidate the will, but will result in the instrument being construed without the deleted provisions. A will may be revised in two ways: First, a codicil may be executed. A codicil is a supplement to a will that adds to, restricts, enlarges or changes a previous will. The Execution of a codicil requires adherence to will formalities. The second and more effective means of revising a will is to execute a new one. The first paragraph of a will typically provides that all previous wills are revoked.

IX. Whether to Destroy or Retain The Old Will

Whether to retain an old will is the subject of some disagreement. This disagreement likely arose because there are situations where the will should be destroyed, and situations where it should not be destroyed. Since a new will expressly revokes the previous will, the natural inclination might be to "tear up" an old will after executing a new one. However, this is not always the preferred course of action. The new will may be lost, secreted, successfully challenged, or for whatever reason not admitted to probate. In this circumstance, the existence of the old will may be of great moment. If the new will is not admitted to probate, an old will may be propounded for probate. If there had been a previous will, but it was destroyed, the decedent will have died intestate. In that case, the laws of descent will

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The Decedent's Last Will, Cont.

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govern the disposition of the decedent's estate. The retention of the old will is insurance against the decedent dying intestate. In intestacy, the laws of descent govern the disposition of the estate.

There are situations where the decedent would prefer the laws of descent to govern. In that case, it would make perfect sense for the decedent to destroy the old will. However, in many if not most situations, the decedent would prefer the terms of the old will to the laws of descent. In these cases, the old will should not be destroyed. To illustrate a situation where the old will should not be destroyed: If a will contestant demonstrates that the decedent was unduly influenced when executing the new will, an older will with similar terms could be propounded for probate. If the decedent had disinherited or restricted the inheritance of the will contestant in the previous will as well, the existence of the old will is invaluable, since a disgruntled heir, friend, or lover would be less likely to mount a will contest. Even if a will contest were to occur, and the will contestant were successful, the victory would be pyrrhic, since the contestant would fare no better under the previous will. Knowledge of the existence and terms of the previous will would also reduce the settlement value.

In some situations the old will should be destroyed: If the new will dramatically changes the earlier will, the testator might prefer the rules of intestacy to the provisions in the old will. Here, destroying the old would obviously preclude its admission to probate; the laws of intestacy would govern. To illustrate, assume wife's previous will left her entire estate to her second husband from whom she recently separated. Under pressure from her children from a previous marriage, wife changes her will and leaves her entire estate to those children. If wife dies, a will contest would be possible. Admission of the old will (leaving everything to her husband) into probate would be the last thing that wife would have wanted. Since intestacy (where her husband takes half the estate) would be preferable to the old will, it would be prudent for wife to destroy the old will (and any copies). Equitable doctrines may come into play where the revocation of a previous will would work injustice. Under the doctrine of "dependent relative revocation," the Surrogate may revive an earlier will, even if that will was destroyed, if the revised will is found to be inadmissible based upon a mistake of law. When invoked, the doctrine operates to contravene the statutory rules with respect to the execution and revocation of wills. If the doctrine is applicable, there is a rebuttable presumption that the testator would have preferred the former will to no will at all.

X. Objections to Probate

Objections to probate, if filed, may delay or prevent the will from being admitted to probate. If successful, a will contest could radically change the testamentary scheme of the decedent. To deter will contests, most wills contain an *in terrorem* clause, which operates to render void the bequest to anyone who contests the will. The effect of the *in terrorem* clause is that the failed bequest is disposed of as if the person making the challenge had predeceased the decedent. Were *in terrorem* clauses effective, will contests would not occur. Yet they do. Therefore, the bark of such clauses appears to be worse than their bite. Still, there is no more reason not to include an *in terrorem* clause in a will than there would be for omitting other boilerplate language. The existence of the clause is not likely to upset most beneficiaries' expectations, and it could cause a disgruntled heir to pause before commencing a will contest.

Although some believe that leaving a small bequest to persons whom the testator wishes to otherwise disinherit accomplishes some valid purpose, doing this actually accomplishes very little. A small bequest to a distributee will neither confer upon nor detract from rights available to the distributee, and consequently would have little bearing on the ultimate success of a will contest. Some testators prefer to use language such as "I intentionally leave no bequest to John Doe, not out of lack or love or affection, but because John Doe is otherwise provided for" or perhaps language stating that the lack of a bequest is "for reasons that are well understood by John Doe."

XI. Liability and Apportionment of Estate Tax

Who will bear the responsibility, if any, for estate tax is an important — but frequently overlooked — issue when drafting a will. The default rule in the EPTL is that all beneficiaries of the estate pay a proportionate share of estate tax. One exception to the default allocation scheme is that estate tax would rarely be apportioned to property passing to the surviving spouse and which qualifies for the full marital deduction. The technical reason for not apportioning estate tax to a bequest that qualifies for the marital deduction is that it leads to a reduced marital deduction, and a circular calculation, with an attendant increase in estate tax.

To qualify for the marital deduction, a bequest to the surviving spouse must pass outright or in a qualified trust. If estate tax is paid from the bequest, then the amount passing outright (or in trust) is diminished. This results in a circular calculation. The same rationale applies to other bequests that qualify for an estate tax deduction, such as a charitable bequest to an IRC Section 501(c)(3) organization. If a large residuary bequest were made to a charity, the testator might want the charity to bear the entire liability for estate tax, even though such a direction in the will would result in a net increase in estate tax liability.

Note that property not included in the decedent's gross estate is never charged with estate tax, even if the disposition occurs by reason of the decedent's death (e.g., proceeds of an irrevocable life insurance trust paid to a beneficiary of the trust). This is because under IRC Section 2033, estate tax is imposed on "the value of all property to the extent of the interest therein of the decedent at the time of his death." Assets not owned by the decedent at the time of his death are not ""interests" within Section 2033, and therefore are not part of his gross estate for purposes of the Internal Revenue Code. The allocation of estate tax

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THE DECEDENT'S LAST WILL, CONT.

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liability is therefore within the exclusive jurisdiction of the decedent's will. The default rule found in the EPTL §2-1.8 can be easily overridden by a provision in the tax clause of the will. This gives the drafter flexibility in apportioning estate tax. In a sense, the ability of the will to control the tax consequences of assets passing outside of the probate estate is an exception to the rule that the will governs the disposition only of probate assets. If the decedent dies intestate, the default EPTL provision will control.

In many cases, the testator will choose the default rule under the EPTL, which is to apportion estate tax among the beneficiaries according to the amounts they receive. As noted, no estate tax is apportioned to assets not part of the gross estate even if those assets pass by reason of the testator's death. For example, the proceeds of an irrevocable life insurance trust are not included in the decedent's gross estate, and any attempt to impose estate tax liability on the named beneficiary of the policy would fail. However, if the insurance policy were owned by the decedent at his death and passed to either a named beneficiary or was made payable to his estate, the beneficiary (or the estate) could and would be called upon to pay its proportionate share of estate tax, unless expressly absolved of that responsibility in the will.

Since the testator is free to change the default rule, the tax clause could direct that estate tax be paid entirely from the residuary estate, "as a cost of administering the estate." Alternatively, the tax clause could direct that estate tax be paid out of the probate estate, meaning that the estate tax would be apportioned to all persons taking under the will. Alternatively, the will might also be silent with respect to the estate tax, in which case the EPTL default rule would govern.

To illustrate the importance of the tax clause provision, assume the decedent's will contained both specific bequests and residuary bequests. Assume further that the decedent owned a $1 million life insurance policy naming his daughter as beneficiary. If the will is silent concerning estate tax, the default rule of the EPTL would control, and every beneficiary, whether taking under the will by specific or residuary bequests, or outside of the will (i.e., insurance policy payable by its terms to a named beneficiary), would pay a proportionate share of estate tax. If the tax clause instead provided that all taxes were to be paid from the residuary estate as a cost of administration, no tax would be imposed on the daughter who receives the insurance, or on persons receiving preresiduary specific bequests under the will.

XII. Revocable Inter Vivos Trusts as Testamentary Substitutes

A revocable inter vivos trust is sometimes utilized in place of a will. Avoiding probate may be desirable if most assets are held jointly or would pass by operation of law. In that case, the necessity of a will would be diminished. Other reasons for avoiding probate may stem from considerations of cost or concerns about privacy. While trusts are generally private, wills are generally public. Letters of trusteeship are not required for an inter vivos trust, since the trust will have became effective prior to the decedent's death, and the trustee will already have been acting. Revocable inter vivos trusts have been said to reduce estate taxes. While technically true, the assertion is somewhat misleading. While a properly drafted revocable inter vivos trust may well operate to reduce estate taxes, a properly drafted will can also accomplish that objective. Revocable inter vivos trusts do accomplish one task very well: They eliminate the need for ancillary probate involving real property situated in another state.

A revocable inter vivos trust is funded during the life of the grantor (or trustor) with intangible personal property such as brokerage accounts, tangible personal property such as artwork, real property, or anything else that would have passed under a will. Assets titled in the name of a revocable inter vivos trust may reduce costs somewhat in certain situations. Unlike a will, a revocable inter vivos trust operates with legal force during the grantor's life. When evaluating the potential probate costs that could be avoided using a trust, one should also consider the cost of transferring title of assets to a revocable inter vivos trust. If probate is not expected for many years, the present value of that cost may not exceed the immediate cost of transferring the testator's entire estate into trust. In addition, assets not transferred to the inter vivos trust will need to be transferred to a "pourover" will, which will be probated. Avoiding probate entirely would be difficult since there are usually assets that have not been transferred into the inter vivos trust.

Most estate planning tax objectives for persons who are unmarried can be accomplished in a fairly straightforward manner using a revocable inter vivos trust. However, unless the bulk of assets are held in joint tenancy, or titled in some other form that avoids probate, avoidance of probate would not likely justify foregoing a will in favor of an inter vivos trust as the primary testamentary device.

SPECIAL NEEDS TRUST, CONT.

(Continued from page 1)

tioning disability trusts, and creating clear rules for their use.

The primary focus of the Medicaid legislation was an attempt by Congress to hinder the affluent elderly from transferring assets into self-settled "Medicaid" trusts by imposing a 60 month "lookback" period. However, Congress also created an exception for disability trusts created for disabled persons under the age of 65 funded with the disabled person's own assets.

In exchange for the promise that Medicaid would be paid back for benefits paid during the life of the disabled child after the trust terminated — usually when the child died — these self-settled disability trusts could be used by disabled persons under 65 to shelter their own assets and thereby qualify for Medicaid. These statutory "first party" trusts are much more restrictive than comparable "third party" trusts, which evolved under common law and which are typically funded by parents' or family members' assets.

Third party trusts are less restrictive since those trusts are not motivated by a desire of the parent to qualify for Medicaid. Rather, they trusts are funded to benefit their disabled child. Third party disability trusts are superior to first party trusts not only because they are less restrictive, but also because they need not contain a Medicaid "payback" provision. Nevertheless, the only option for funding a child's disability trust may at times be a first party trust.

Also in 1993 New York codified *Matter of Escher*, 52 NY2d 1086 (1981), a Court of Appeals decision involving a testamentary trust created for a disabled child. In *Escher*, the New York Department of Mental Hygiene sought reimbursement for care provided to the decedent's daughter in a psychiatric facility for 30 years. The Surrogate found that the trust contained in *Escher's* will expressed his clear intent to leave assets to the daughter's distributees. Finding for the estate, the Surrogate reasoned that if the corpus were paid to New York in 1978, that would leave nothing for those distributes. This would conflict with the clearly stated intent of the testator.

Affirming the decision of the Surrogates Court rejecting the claim, the Surrogate concluded that the desire of a parent to supplement the standard of living of a disabled child was not dependent upon the benevolence of the law, and that the government entitlement is a floor, rather than a ceiling. New York appealed the case to the Court of Appeals, which affirmed the Surrogate in a landmark decision. Against the backdrop of *Escher* and the federal changes, New York enacted EPTL §7-1.12, under which disability trusts have gained prominence.

Sheltering Assets to Qualify
<u>Qualify For Medicare and SSI</u>

Enabling the disabled child to receive means-tested government benefit programs requires that trust assets not be considered "available" assets for government benefit programs. Special needs trusts ("SNTs") shelter assets and render those assets an "unavailable resource" for purposes of applying eligibility rules for disabled persons receiving health care coverage under Medicaid, or income support under Supplemental Security Income (SSI).

Medicaid provides direct payments to providers for health related costs, whereas SSI provides income directly to disabled persons. In New York and most States, qualification under SSI will automatically entitle the disabled person to Medicaid. The loss of SSI benefits may result in the loss of Medicaid. SSI is federal program that provides monthly payments to people with limited income and few resources.

[New York is among the states that make "State Supplemental Payments (SSPs). Some states' supplemental payments are administered by the Social Security Administration (SSA). Those 12 states include CA, DE, NJ, PA, RI and VT. New York is among the 33 states that pay and administer their own SSPs. Six states do not offer SSPs: AZ, AR, MS, ND, TN, and WV.]

While SSI is a federal program of income assistance, Medicaid is a joint federal-state program of medical assistance, administered by the states. States determine Medicaid eligibility and the scope of health services offered pursuant to federal requirements. The legal authority for Medicaid is found in the Social Security Act, 42 USC §1396 *et seq.* Unlike SSI, Medicaid makes payments only to third parties. Like SSI, Medicaid is need-based. Medicaid is actually a group of programs, with differing benefits, rules, and eligibility requirements.

Medicare and Social
<u>Security Distinguished</u>

As an aside, Medicare and Social Security are examples of government programs that are <u>not means-tested</u>. Social Security, funded by payroll tax, is based on one's earnings record, and is available to persons age 62 or over, or to those who are disabled or blind. Medicare is age-based, and is available to citizens or permanent legal residents age 65 or over.

<u>Objective of Special Needs Trust</u>

The choice of a trust by Congress to accomplish its objective was judicious, since a trust provides flexibility to serve the needs of the disabled person. EPTL §7-1.12 governs Special Needs Trusts in New York, and provides helpful trust language intended to make compliance with means-tested government and private programs more predictable. Special needs trusts are also referred to as "Supplemental" Needs Trusts, using the same acronym.

An SNT improves the quality of life of the disabled child by paying for enhanced medical care, such as premium health insurance, health services and medical equipment. The trust may also help the child become independent by purchasing a residence or by funding more comfortable housing. The trusts also serve a myriad of other purposes, one of which is to ensure continued care after family members are deceased. (A "letter of intent," or a "future care plan" is important when family members are gone and will be discussed later.) The assets of a special needs trust, when not used for shelter or food, will not "count" for purposes of SSI or Medicaid, and can thus be utilized to improve the living

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SPECIAL NEEDS TRUST, CONT.

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standard of the disabled child.

Special needs trusts are particularly useful in providing for items that are not provided by means-based government programs or by private insurance. These may include transportation, vocational training, computers, personal care givers, vacations, and many other items.

The special needs trust, like any trust, is not a legal entity. Rather, a special needs trust is a *relationship* wherein the trustee holds property for the benefit the disabled person, or *cestui que trust*. A division of ownership occurs between the trustee, who holds legal title, and the disabled beneficiary, who holds equitable title. Trusts evolved in England because of the inherent limitations of law courts to provide equitable relief.

Special needs trusts appear to be a hybrid form of several different types of trust. An SNT generally contains an anti-alienation provision, a feature of spendthrift trusts. An SNT also bears some resemblance to a discretionary trust, since the trustee alone decides when to distribute income or principal. The discretionary element of an SNT is tempered by the limitation imposed on the trustee not to exercise this discretion in a manner that would jeopardize the beneficiary's eligibility for publicly or privately funded benefits.

An SNT differs from a support trust in that the trust must carefully circumscribe the benefits the trust may provide without becoming an "available resource" which would preclude means-tested government assistance. To avoid being an available resource, an SNT must also be irrevocable. However, the trust may contain provisions allowing amendment or modification if circumstances warrant. For example, modification might be necessary in order to become eligible for a means-tested benefit program whose requirements have changed. A court might also allow modification where the law has changed.

Improving the life of the disabled person, most often a child, without affecting eligibility for public benefits requires an understanding of public benefit programs available to the child. Each program may have different eligibility rules. The objective of a properly drafted SNT is to be treated as "exempt" by government agencies providing means-tested benefits. A special needs trust must be skillfully administered by the trustee since an improper distribution could entail the loss of benefits to the child.

Several distinguishing characteristics are present in all special needs trusts: First, they must be irrevocable. Revocable trusts will be considered an available asset and will render the trust defective for SNT purposes. Second, the person must be under the age of 65 and "disabled" within the meaning of the Social Security laws. (Persons over 65 receive governmental benefits by reason of their age). Third, with respect to first party trusts, which are funded by the disabled child, the trust must include a Medicaid "payback" provision. This provision requires that the trust reimburse Medicaid for the cost of Medicaid services provided. After Medicaid has been reimbursed, remaining trust assets may be distributed to contingent remainder beneficiaries. First party trust are also subject to other unique requirements, discussed later.

A *testamentary* special needs trust takes effect upon the death of the grantor (settlor). It may be a separate document or a provision in the testator's will. An *inter vivos* SNT is separate legal document, executed during the grantor's lifetime. It is usually funded during the grantor's lifetime, but may also be funded at the grantor's death. One reason to implement an SNT for a minor child is to facilitate lifetime gifts or testamentary bequests from grandparents or other family members. Without an SNT in existence (and without a potential benefactor knowing of its existence) the funds might be left outright to the disabled child. This would limit the child to establishing an inferior first party special needs trust. First party trusts may also be the only option if the child must take legal possession of substantial assets, such as when the child receives a tort settlement.

An *inter vivos* SNT may be appropriate for a parent or parents who wish to purchase an insurance policy during the child's adolescence. The policy would be owned by the trust and premiums could be gifted by parents to the trust. A second-to-die policy owned by the trust could provide substantial benefits to the child without affecting means-tested government benefits. Such an arrangement would also prevent a "lag" period during which the SNT could not provide assistance to the child following the passing of the surviving parent.

Whether a special needs trust is appropriate for a disabled child depends on (i) whether the child is receiving means-tested government benefits or whether such benefits may be sought in the future; or (ii) whether the disabled child might receive bequests from family members other than parents. If the trust is implemented to hold an insurance policy, or if the child may receive non-means-tested ("waivered") benefits, the SNT may be an appropriate choice. The child may not be eligible for means-tested benefits during child's minority, which ceases when the child turns 18 due to the parents' legal obligation to support the child during minority.

If the disabled child does not require a special needs trust, it may be prudent to consider a less restrictive discretionary support trust, which provides for many of the benefits of the special needs trust, such as management of trust assets and asset protection. Since government benefits will likely not be sought, the distribution standard could be far more permissive, perhaps employing the familiar "health, education, maintenance and support" (HEMS) standard.

Family wealth may also obviate the need for means-tested government benefits, in which case a discretionary trust might also be appropriate. Not all government benefits are means-tested, although most are.

II. EPTL § 7-1.12

EPTL §7-1.12 was enacted in 1993 to facilitate the creation of disability trusts for disabled children by family members. It provides clear guidance in establishing a "statutory" special needs trust. Under the model statutory language for third party trusts, a trustee's discretion is limited only when the distribution would ad-

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versely affect the beneficiary's benefit eligibility. For first party trusts, the trustee's discretion is significantly more limited. EPTL §7-1.12 requires that the trust be restrictive in order to prevent assets from becoming "available" assets.

The trust should always include language indicating that the intent of the settlor is to establish a trust fund for the benefit of the disabled child. The trust should also contain the following or similar language restricting expenditures that could affect government benefits:

> None of the income or principal of this trust shall be applied in such a manner as to supplant, impair, or diminish benefits or assistance of any federal, state, county, city or other governmental entity for which the beneficiary may otherwise be eligible or which the beneficiary may be receiving.

The trust should also state that the beneficiary has no power to assign, encumber, direct, distribute, or authorize distributions from the trust. The trust must include language prohibiting the trustee from taking any action that would impair the eligibility of the disabled child for receiving public benefits.

Any person may establish a testamentary trust for the benefit of a disabled person, not only a parent. The statute at first blush appears to preclude a parent from establishing a disability trust for a child under the age of 18, since the parent has a legal obligation of support. However, if the trust does not affect the parents' legal obligation of support, there appears to be no reason why a parent of a child under 18 not seeking government assistance could not establish a third party special needs trust to accomplish other important objectives.

The more sensible interpretation of the statute is that the support prohibition should not apply to children who either receive either no government benefits or only receive benefits under a "waivered" program. In those cases there would be no rationale for including a Medicaid payback provision in the trust. On the other hand, if the child **is** receiving means-tested government benefits as a minor, the child must be 18 or older before a no-payback special needs trust can be established due to the parental obligation of support.

Granting the Trustee Flexibility
to Forego Government Benefits

Following the suggested language in EPTL § 7-1.12 might conflict with the trustee's judgment as to what is in the child's best interest. The required language might preclude distributions of food, clothing, shelter, or medical care covered by a benefit program. The prohibition would reduce the risk of noncompliance with the benefit program, but paradoxically might not always be in the best interest of the child.

The trustee might reasonably and conclude the benefit of a distribution would exceed the loss of government benefits in a particular case. For example, the trustee might wish to subsidize the beneficiary's rent so that the child could be placed into a more commodious living arrangement. This would reduce the monthly Supplemental Security Income (SSI) benefit by a maximum of 1/3. Since the distribution would adversely impact a government benefit it would be prohibited under the most restrictive trust language found in EPTL §7-1.2.

EPTL § 7-1.12 provides a solution, which is addressed by including trust language authorizing the trustee to deviate from the prohibition against reducing government benefits if the trustee believes that the distribution, despite impacting government benefits, would be in the best interest of the child. Suggested language also appears in EPTL §7-1.12.

However, a governmental agency might later decide that program eligibility will be adversely affected if the trust provides that the trustee may make discretionary distributions despite the loss of government benefits. Here, additional suggested language also sanctioned under the statute could be included, allowing the trustee to "opt-out' of the trust provision allowing distributions even though such distributions would adversely affect eligibility for government programs. In essence, the relationship of the trust to the agencies providing benefits becomes a "cat and mouse" game if the two optional provisions are included in the trust.

It could be argued that this "toggling" feature actually undermines the restrictive nature of the trust, and makes the trust tilt more toward the discretionary spectrum, which might be regarded as against the public policy of the statute. However, since the additional language does have the imprimatur of the New York legislature, an agency providing benefits might be somewhat more reluctant to challenge a trust benefitting from trust language allowing what amounts to built-in modification. When one weighs the benefit to the child versus the risk (cost) to the agency providing the benefits, the provision of benefits to the child may outweigh the gatekeeping function of the agency.

There is another important policy reason for the language allowing the trustee to forego government benefits in the best interest of the child: It recognizes the possibility that the beneficiary at some future time might not participate in a government program. If that were the case the child would be best served by allowing the trustee greater discretion.

Interestingly, it is not entirely clear that discretionary support trusts not meeting the requirements of EPTL § 7-1.12 would necessarily result in ineligibility for means-tested government benefits. For example, the Social Security Administration does not treat discretionary support trusts as "countable" assets if the beneficiary cannot compel distributions. POMS SI 01120.200. However, it is clear that a trust which grants the trustee unlimited discretion to provide for general support of the beneficiary would jeopardize qualification under Medicaid, SSI and other means-tested government benefit programs.

Distribution Standard
Under EPTL §7-1.12

The distribution standard for special needs trusts suggested by EPTL § 7-1.12 range from extremely restrictive, to less restrictive, to an op-

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tion to "toggle" between the two. If an SNT is deemed too restrictive, then the parent might instead consider a discretionary support trust. While the least restrictive option, this type of trust would might not achieve eligibility for means-tested government benefits.

Twin objectives of the SNT are to (i) employ the least restrictive distribution standard necessary to maintain compliance with eligibility criteria for means-tested government benefits now and in the future; while at the same time (ii) making maximum use of trust assets to improve the child's quality of life. Since future eligibility requirements cannot be predicted, and even if they could be predicted, the child might not need a particular benefit, the trust should be capable of being amended or modified.

Whatever the distribution standard chosen, in interpreting the trust, under *Escher* and EPTL §7-1.12(a)(5)(i), courts will likely examine the parents' clearly stated intent. Therefore, a clearly stated intent to preserve government benefits coupled with the beneficiary's inability to directly or indirectly control distributions should allow for a more flexible distribution standard that would pass judicial scrutiny.

The strict distribution standard refers to the limitations placed on the trustee in making distributions that would curtail means-tested government benefits. What the statute forbids are distributions for "basic needs," which consist of food and shelter (or distributions that would imperil government benefits). The trust must also prohibit the distribution of cash to the child. However, a trust can provide for a multitude of "special needs" that are not "basic needs."

Thus, the trust might allow the trustee to make distributions for internet, cable television, or even a vacation. There are virtually limitless other permitted expenditures. To refine the point, the trust may prohibit distributions for basic needs such as food and shelter, and cash, but could expressly permit distributions for virtually anything else that has no impact on means-tested government programs.

If a flexible distribution standard is employed, then distributions even for basic needs may be allowed if the distribution is in the best interest of the disabled child. When drafting the trust, it seems appropriate to enumerate expenses that the trustee may incur for the child, even though the list may be stated as being "illustrative," rather than "exhaustive." This would enable the trustee to make expenditures without having concern as to their propriety, aside from restrictions imposed by the statute.

For example, the child may have enjoyed a previous vacation to Disneyland in Anaheim. An explicit provision allowing a vacation there might also impliedly justify expenditures for other vacation destinations. Moreover, though such an expenditure would in all likelihood be appropriate without the provision, if the expense were substantial — as it likely would be — having the explicit provision in the trust would facilitate a decision of the trustee to allow the expenditure. If parents accompanied the child, it is conceivable that the trust could cover the entire vacation expense.

Early Termination

If the trust no longer serves its intended purpose, it may be desirable to terminate the trust. The trust might provide for termination if the beneficiary became employed for a continuous period of two years or otherwise loses eligibility for government entitlements; that a physician familiar with the beneficiary certifies that the disability no longer limits him or her from being gainfully employed; or that the trustee in his sole discretion determines that the facts warrant early termination. If the requirements for termination are clearly stated in the trust, the risk of a contingent beneficiary objecting to the termination appear low. In a case of a first party trust, Medicaid would presumably require repayment of benefits paid until the time of trust termination.

III. Third Party Special Needs Trusts

Most special needs trusts are third party trusts funded by persons other than the disabled child — usually parents and grandparents. They are superior to first party trusts, but are not possible if the trust is to be funded by the disabled child himself. Unlike first party trusts, third party trusts need not contain a Medicaid payback provision, and their terms need be far less restrictive than their first party trust counterpart.

A third party trust may provide lifetime benefits to the child (assuming the disability lasts that long) with trust assets passing to remainder beneficiaries named in the trust. Third party special needs trusts effectively shelter assets so that they are "unavailable" and therefore will not impact eligibility for means-based government programs.

To be effective for their intended purpose, trust language must comply with EPTL §7-1.12. Failure to so comply will not invalidate the trust *per se*, but it will most likely render the trust ineffective in obtaining SSI benefits, and will likely adversely impact eligibility for means-tested government benefits. The trust will still operate, but will not provide the benefits of a special needs trust. It will be internally contradictory, difficult to administer, and might require court involvement.

A third party special needs trust is typically funded either during the lifetime of the parents or at their death. Once funded, the trustee will have control over the assets distributed to the disabled child. Funding the trust during the parents' lifetime will ensure that the trust is in effect when both parents are no longer alive. Lifetime funding may also reduce potential estate tax liability of the parents by removing an appreciating asset from the parents' taxable estates.

Other tax benefits can also be achieved with proper tax planning. As noted, special issues arise when implanting a third party trust for a minor if means-tested government benefits are being sought, since parents have a legal obligation to support their child until the age of 18.

IV. First Party Special Needs Trusts

New York and most other jurisdictions bar a settlor from creating a self-settled, asset-protected trust in

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which the settlor is also the only beneficiary. EPTL § 7.3.1(a) provides that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator." Accordingly, first party special needs trusts did not exist under the common law. However, as a result of the 1993 federal Medicaid legislation, first-party self-settled special needs trusts were sanctioned. Since federal law trumps state law under the "preemption doctrine," New York then enacted a limited exception for self-settled trusts in the context of those which qualify under federal law. That exception was included in the language EPTL §7-1.12.

Under federal Medicaid law, a disabled beneficiary may "self-settle" a special needs trust with assets owned by the disabled child himself. The assets might derive from a tort settlement, an inheritance, or a gift. The common thread is that the assets legally belong to the disabled child. However, first party trusts—in contrast to third party trusts — must contain a provision requiring the trustee, upon the death of the child, to reimburse Medicaid to the extent of remaining trust assets, for all amounts paid for the child during his or her life. Any trust assets remaining will pass to residuary beneficiaries named in the trust.

Since a first party special needs trust is an exception to the doctrine barring self-settled trusts, permissible distributions from a first party special needs trust are circumscribed, and much more restrictive than distributions from third party trusts. The exception traces its lineage to the federal Medicaid statute revised in 1993. In addition, several eligibility requirements are exclusive to first party special needs trusts.

The Medicaid statute enumerates those requirements: First, the assets must come from an individual under the age of 65; second, the person must be "disabled" as defined under the Social Security law; third, the trust must be "established" by a parent, grandparent, legal guardian, or court; and fourth, there must be a "payback" provision in favor of Medicaid when the beneficiary dies.

The enabling statute, 42 U.S.C. §1396p(d)(4)(A) provides:

> "[there shall be no transfer penalty to] a trust <u>containing the assets of an individual under age 65</u> who is disabled . . . and which is established for the benefit of such individual by a parent, grandparent, legal guardian of the individual, or a court if the state will receive all amounts remaining in the trust upon the death of such individual up to [the total Medicaid outlay]. (Emphasis added).

Although the disabled child will be contributing his or her own assets to the trust, he or she may not "establish" the trust. The trust must be established by a parent, grandparent, legal guardian, or court. Creation of the trust by a parent or grandparent is optimal because that will in most cases obviate the need for court approval. However, if the child is a minor or lacks capacity, a guardian *ad litem* may be need to be appointed. In that case, court involvement would be required.

In permitting first party special needs trusts, Congress has given special dispensation to disabled persons wishing to create trusts for their own benefit which will not impair government assistance. The disabled person is sheltering assets when transferring those assets to the trust. Yet for purposes of Medicaid and SSI, such transfers are not penalized and the assets will be respected as sheltered for purposes of Medicaid and SSI. The transfer will not affect benefit program eligibility, and the principal and income of the trust will continue to be exempt. (Whether the assets would be sheltered from claims of other creditors of the child is an interesting question.)

The inferiority of first party special needs trusts when compared to third party trusts reflects an attempt to reconcile the exception for first party SNTs with the general rule in New York prohibiting self-settled trusts. Since the federal Medicaid statute contains a carve-out allowing self-settled first party special needs trusts, the NYS Department of Health issued regulations which require the trustee to notify the local Social Services district of the creation and funding of a special needs trust established for the benefit of the applicant for Medicaid when the trust is funded with the applicant's own assets.

V. Deeming Rules and Parental Obligation of Support

SSI considers income and assets of parents of minor disabled children as "available" and countable for eligibility purposes. Disabled children under the age of 18 may therefore not qualify for public benefit programs because their parents' income is "deemed" available to them. Parental deeming ceases once the child reaches age 18. At that time, the child may well qualify for SSI, Medicaid and other government and private benefits.

Some means-tested government benefit programs contain "waivers." If so "waivered," the income of parents is not relevant in determining the child's qualification for the benefit. This may occur, for example, where a severely disabled minor child returns home from an institution.

Interestingly, there appears to be no bar to a grandparent not under a legal obligation to support the minor disabled child from making a bequest to a no Medicaid payback supplemental needs trust before the child reaches the age of 18. However, the trustee would in most cases be precluded from applying for means-tested benefits by virtue of the "deeming" rules.

Although a bequest made to a special needs trust by a grandparent for the disabled child during his or her period of minority could not benefit the child with respect to means-tested benefits until the child attained the age of majority, once the child does reach age 18, and becomes eligible for means-based benefit programs, the previously funded SNT would presumably be sheltered for purposes of SSI and Medicaid, and could provide significant benefits.

In contrast, if no SNT exists for the child during the period of the child's minority, a grandparent wishing to make a bequest could only make the bequest directly to the child. This would limit the child to implementing

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an inferior first party trust. Therefore, by the expedient of having even an unfunded third party trust in place to act as a receptacle for gifts from grandparents and others, a third party trust established during a period of minority either by a parent or by a grandparent to enable the child to qualify for government benefits when the child reaches the age of 18, would seem to not require a Medicaid payback provision.

A third party trust were created for a minor child should be named as the legal entity receiving any bequest from a parent or grandparent. It would defeat the purpose of the third party trust for a bequest to be paid to the child directly, because that would limit the child to creating a first party trust. The mistake of not making the gift to the trust would be difficult to correct. Once the bequest is "accepted" by the child, legal title to the assets pass to the child by operation of law. Retitling the asset into the name of an existing SNT will not be equivalent to the grandparent or relative having made a bequest directly to the SNT. Only a first party SNT could be considered.

Curiously, there may be one solution to a gift or bequest made by a grandparent to the child directly when a third party trust is in existence. That solution involves the child disclaiming the bequest. However, for this possible solution to be considered, several facts must be established: First, the disclaimed property must pass to the parents; second, the child must not have accepted any benefits; and third, the disclaimer must be effective.

If the bequest is made by will, then the disclaimed property must pass by operation of law to the parents. If this is not the case, then disclaiming the property would not be an option. However, if the disclaimed property were to pass to a parent, then the child must not have accepted any benefits of the disclaimed property. This requirement will likely have been met. Merely transferring the property to the bank account of the child would not be considered as the child having received benefits to disqualify a disclaimer.

Finally, the disclaimer must be effective, which means that it must be consummated within 9 months of the bequest. The disclaimer would likely require court involvement, and might take more than 9 months to effectuate. A guardian ad litem would need to be appointed. There is also the problem of the bequest passing to the parent, who would then not be under a legal obligation to fund the third party trust either now, or more likely, when the child turned 18. However, a Court might approve a parent taking legal title to the bequest if the funds were held in escrow.

VI. Supplemental Security Income and Resource Rules

Supplemental Security Income (SSI) is a federal monthly cash income benefit provided to people with very low income and resources who are either aged (65 and over), blind or disabled. It is administered by the Social Security Administration (SSA). SSI eligibility depends on age, disability and need, but not work history. Qualification for SSI usually results in automatic qualification for Medicaid. The legal authority for SSI derives from the Social Security Act. 42 USC §1381 *et. seq.* Policy guidelines are found in the **Program Operations Manual System (POMS)** on the Social Security Administration website. SI 00500.000 *et. seq*. The POMS sections relating to special needs trusts were revised effective April 30, 2018.

Although in New York and other States, qualifying for SSI will result in automatic qualification under Medicaid, the converse is not true: Not all Medicaid recipients qualify for SSI. This is significant, because many means-tested programs reference SSI and not Medicaid in determining eligibility.

In New York, SSI recipients receive two deposits: one from the federal Social Security Administration (SSA), and one from the New York State Office of Temporary and Disability Assistance (OTDA) for the State Supplemental Payment (SSP) portion of the benefit. In New York, SSI recipients who live alone automatically get SNAP (Supplemental Nutrition Assistance Program) through NYSNIP (New York State Nutrition Assistance Project). Monthly cash income is typically direct-deposited into a recipient's bank account.

SSI eligibility references income and assets. A person must have no more than $2,000 in available resources and little or no income. Some assets are not "countable" as resources: Those assets include the beneficiary's home, one automobile, household furnishings, prepaid burial expenses, tools of the beneficiary's trade, and several other items.

Money received in a given month is income. Any money remaining at the start of the next month becomes an asset. "Countable" income is used to determine SSI eligibility; "excluded" income is not counted. "Unearned" income refers to income received without the performance of work. Gifts and investment income constitute unearned income.

Unearned income reduces SSI benefits dollar-for-dollar. Earned income is treated more favorably. However, since an SSI recipient is a person with a disability rendering him or her "unable to perform any substantial gainful activity," a significant amount of earned income might cause a termination of SSI benefits.

Special Needs Trusts Not a Resource If Properly Drafted

Given that the purpose of special needs trusts is to ensure that assets owned by the beneficiary are not available resources for purposes of means-tested government programs such as SSI and Medicaid, a properly drafted SNT should comply with the requirements of both the Medicaid statute and the rules for SSI as found in POMS.

With respect to Medicaid, the special needs trust must be drafted to comply with the Federal Medicaid Statute found in 42 U.S.C. §1396(d)(4). The situation with POMS (for SSI purposes) is more complicated: POMS provides that compliance with the federal Medicaid statute is necessary but not sufficient. The trust must still be evaluated to determine whether it is an available resource.

In New York, a trust in which the grantor is also the sole beneficiary is deemed to be revocable, even if the trust provides that it is irrevocable. Under SSI, a revocable trust is

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considered a countable resource. This would seem to disqualify a first party special needs trust, because the disabled child is both the grantor and beneficiary. However POMS provides in a section applicable only to New York and New Jersey that a trust will not be deemed revocable if residuary beneficiaries consist of (i) a named living person, (ii) "issue" (if living, and the grantor's issue), or (iii) the State of New York.

Receipt of lump sums may be problematic and are addressed in POMS. A court order directing a lump sum be paid directly to a trust may result in the payment being deemed irrevocable and thus not countable income. This could apply to a tort settlement, alimony, or child support. Some payments such as Social Security, federal or state pensions, and veterans benefits, are not assignable. There is no transfer penalty for transfers into a special needs trust for a disabled individual under age 65.

In-Kind Support and Maintenance

In-kind distributions by parents of food or shelter reduce SSI payments by a maximum of 1/3. In-kind payments of items other than goods and services will not reduce SSI payments. Medicaid does not track in-kind distributions. Medicaid is only concerned with income and resources actually available to the disabled child.

Payments for food and shelter are considered "necessities of life," and when made by parents to a third party will be treated as "countable" income. However, the amount of countable income for SSI purposes is not the amount actually paid to the provider. Rather, the SSI monthly benefit is reduced by the lesser of

(i) the value of the items provided; or

(ii) 1/3 of the SSI benefit.

For 2023, the federal SSI benefit for a single person is $914; the New York supplemental benefit is $87.

Illustration. John is disabled due to a serious physical or mental illness and is receiving federal SSI benefits of $914 per month. Father gives John $700. The income is "countable" and reduces the SSI benefit dollar-for-dollar to $214, regardless of how John spends the money. Now assume Father buys John $700 of food. The $700 is still "countable," since it was used to buy food or shelter, which are "necessities of life." One-third of the SSI benefit is $305. Since $305 is less than $700, John's monthly federal SSI benefit is reduced by $305, to $409.

Now assume Father gives John $500 to buy food. John's monthly SSI benefit is reduced dollar-for-dollar by $500, to $214. If John had instead used the $500 to buy a bicycle, his SSI would also be reduced by $500. If John's father had instead purchased the bicycle for John, John's SSI benefit would be unchanged since a bicycle is not a "necessity of life," which is limited to food or shelter. Finally, assume Father buys John an iPhone for $1,500. Since the in-kind distribution was not for food or shelter, it is also not "countable." John's SSI benefit would be unaffected. If Father had given John $1,500 to purchase the iPhone, John's SSI benefit would be reduced to 0.

Parents of a disabled child receiving SSI might elect to pay the rent of their child at an adult care facility. That that payment, being a "necessity of life," would reduce the SSI benefit by 1/3, regardless of the amount of the rental payment. Therefore, if parents made a monthly rental payment of $2,000 for their disabled child receiving monthly SSI of $914, the SSI benefit would be reduced by $305, to $609. This might be an acceptable trade off, and the trustee might deem the reduction in SSI benefits for the improved living arrangement in the best interest of the child.

The discretion of the trustee of an SNT to make this payment — that is, to forego the full SSI payment in order to improve the life of the child — is an important feature of the optional language suggested in EPTL §7-1.12. Since Medicaid eligibility references SSI eligibility in New York, loss of Medicaid would appear not to be problematic.

The drafter of a third party SNT has two basic options at the outset: The trustee may be prohibited from making any payments or distributions to the child for "necessary expenses" or expenses that could undermine eligibility for government benefits. This route is safest, since violation of intricate rules governing Medicaid and SSI are unlikely to be violated. Although safest, this is not necessarily the preferred option.

Most settlors would choose to confer upon the trustee discretion with respect to in-kind distributions of food or shelter even though such distributions that might reduce SSI benefits. No special concern exists for in-kind distributions of items other than food or shelter, since those in-kind distributions will not affect SSI benefits.

When making an in-kind distribution for housing, it is important that the distribution not violate any of the highly technical rules governing public benefit programs. Failure to adhere precisely to those rules could conceivably cause a termination of SSI benefits. Since Medicaid is tied to SSI, losing SSI would also possibly cause a loss of Medicaid benefits. Therefore, one must tread lightly employing a more flexible standard when drafting the trust. The trustee must tread even more lightly when actually making such an in-kind distribution pursuant to trustee discretion.

VII. Trustee Considerations

The parent may be a suitable, even preferred trustee of an SNT. The parent serving as trustee should be familiar with the government benefits the child receives or is likely to receive. The parent may enlist the help of an attorney in this regard. A financial advisor can also be retained. Tax advisors will also be necessary to timely file fiduciary tax returns. Many special needs trusts require that the trustee be bonded by a commercial surety company.

Matter of J.P. Morgan Chase

Matter of the Accounting of J.P. Morgan Chase Bank, N.A., 956 NYS 2nd 856 (N.Y. Surr. Ct., 2012) examined the extent to which a fiduciary has an affirmative duty to ensure that

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the needs of the beneficiary of a special needs trust are met. The case illustrates that the grant of "full discretion" may require the trustee to invest more time and attention to a disabled child.

Mark, who was autistic, had a well-funded trust that had implemented by his mother. Both parents became deceased. Mark was living in a Medicaid-funded residential program for individuals with autism. It was the responsibility of *J.P. Morgan* to determine how private dollars should be spent to supplement the care Mark was receiving. The Surrogates Court in reviewing the account of the trustees determined that while the bank took commissions and fees, practically nothing was spent on Mark until the Court intervened. The trust sat "dormant" for years. The Court determined that *J.P. Morgan* was not entitled to compensation because it failed to be proactive in identifying the needs of the beneficiary:

> It was not sufficient for the trustees merely to prudently invest the trust corpus. . . The trustees here were affirmatively charged with applying trust assets to Mark's benefit. . .Both case law and basic principles of trust administration and fiduciary obligation require the trustees . . . To keep abreast of Mark's condition, needs, and quality of life, and utilize trust assets for his actual benefit.

J.P. Morgan ultimately retained a private social worker to determine how Mark's life could be improved through the prudent use of trust funds. As a result, Mark's life in fact improved greatly. The case illustrates the need for even an institutional trustee to engage other professionals who can assist in managing the needs of the disabled child, especially in situations where the parents are gone and there are no other persons who could fill the void in advising the trustee of the child's needs. The case also underscores the need for an effective and comprehensive letter of intent, discussed below.

VIII. Tax Considerations

A first party special needs trust would typically be a grantor trust for income tax purposes since the child contributes the trust assets and remains the beneficiary. First party SNTs are usually funded with the proceeds of a tort litigation or from an outright inheritance. Since this trust is authorized by the Medicaid statute, 42 U.S.C. §1396p(d)(4)(A), it is sometimes referred to as a (d)(4)(A) trust.

Although the child retains the right to income and principal of the trust, the child's interest is restricted since the trustee has full discretion with respect to distributions, and can only make distributions that will not impair benefits the child receives from governmental programs.

Since grantor trusts are ignored for federal income tax purposes, income from a first party trust will be taxed to the disabled child, who will typically be in a low income tax bracket and may have large medical expenses that will be deductible.

In some circumstances it may be prudent to seek to have the trust taxed as a nongrantor trust for income tax purposes. This can be accomplished by the trustee relinquishing certain powers. In that case, the trust would be a separate taxable entity.

Third party SNTs are usually funded by parents or grandparents of a disabled child. If created during the parents' lifetime, the trust would be a separate document. If created at death, it would typically be incorporated into a will. To be effective, the trust must be irrevocable. Although a will may be revoked, if it contains a testamentary SNT, the irrevocability requirement is satisfied, since the trust will become irrevocable when the parent dies.

If the third party SNT is created during a parent's lifetime, the trust can be structured to be either a grantor or a nongrantor trust. In general, grantor trust status is preferable, since the trust corpus will continue to grow tax-free without the imposition of income tax. The status of a trust as a grantor trust created by a parent would terminate at the death of the parent. At that point, the trust would become a non-grantor trust.

If the third party SNT were drafted as a nongrantor trust, the trust would report income, file its own tax return, and pay taxes from trust income or principal. The trust would be subject to the compressed trust tax rates, so accumulated income would be taxed at a higher rate than if the trust were a grantor trust.

IX. Letter of Intent

During the life of the disabled child, the parents will be able to best assess the progress of the child and attend to his or her needs. However, the child may outlive both parents, and the trust may continue to operate. It is apparent that the terms of even a well-drafted trust that served the child well during the life of the parents would then be insufficient alone.

Filling this void is an issue which should be addressed during the life of the parents. As a first step, the parents will have typically named a guardian to make legal decisions outside the ambit of the trustee. If a parent were serving as trustee and has continued in that fiduciary capacity until death, it would be extremely helpful if the new trustee had a document which contained important information about the child.

To assist the new trustee, as well as a relative or family friend who may participate in the care of the child, a "letter of intent" could prove to be an invaluable resource to the new persons or entities now charged with not only administering the trust, but helping the disabled person deal with the loss of parents and the child's new life challenges. The letter need not be drafted all at once. It can be prepared throughout the child's life, and supplemented with important medical or other documents as necessity dictates.

The letter of intent should be thorough and contain financial and other information helpful to a new trustee, be it an individual or institution. Other relevant information, such as the child's medical situation, personal preferences for food and recreation, and important contacts might be included. While preparing a letter of intent plan is possible after the parents are gone, the quality of a letter drafted by another family member, or even an-

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other person with knowledge of the child's circumstances would not approach that prepared by the parent or parents.

In situations where the special needs trust appears in a testamentary document, most likely as a provision in a will, it is even more important that the letter be comprehensive. Here, the trust will be nascent and trust provisions are likely to be much less detailed than if the trust had been operating as a separate instrument during the parents' lives.

The loss of both the child's parents will undoubtedly be very difficult for the child to cope with. Anything which helps the new caregivers deal with the child's loss — pictures and mementos — will make it easier for the child to deal with his or her grief.

X. ABLE Accounts

An ABLE account allows individuals with disabilities and their families to save for qualified disability-related expenses on a tax-free basis without adversely affecting the child's ability to benefit from Supplemental Security Income, Medicaid, and other means-tested government benefit programs now or in the future. Since the ABLE account does not affect these eligibility for these government benefit programs, an account may be used either as a stand-alone substitute or in conjunction with a special needs trust. ABLE stands for "Achieving a Better Life Experience Act of 2014."

NY ABLE is intended to qualify under IRC Sec. 529A. The program is managed by Ascensus Broker Dealer Services, LLC. Ascensus has responsibility for day-to-day operations, including investment advisory, record-keeping, and administrative services. Except to the extent of FDIC insurance provided for the checking option, neither New York or its agencies, nor Ascensus or its affiliates, guarantees the principal deposited or any investment returns.

A parent or legal guardian, or a disabled person him or herself under the age of 26 may open an account if the person (i) is either entitled to SSI or (ii) meets special criterial for disability. Proof of eligibility is not required to open an ABLE account; it is nevertheless advisable that the parent maintain a benefits verification letter, a record of diagnosis, or other proof of eligibility. An account may be opened online for $15, or by paper application for $25.

The maximum contribution to an ABLE account in 2023 is $17,000 from all sources. Each State sets its own maximum account limits. In New York, the limit is $100,000 for persons receiving SSI. For persons not receiving SSI, the maximum account balance is $520,000.

Account balances grow tax-free. <u>Amounts paid for qualified disability expenses are not taxed, and will not adversely affect Medicaid or SSI benefits</u>. Amounts withdrawn and not used for qualified disability expenses are taxed as income, and will be subject to a 10 percent federal tax penalty. Withdrawals can be made by phone, online, with a NY ABLE debit card or by check.

Funds may be used for disability-related expenses that assist the beneficiary in improving or maintaining health, independence, or quality of life. Qualified disability expenses include expenses related to education, health and wellness, housing, transportation, legal fees, financial management, employment training, assistive technology, personal support services and oversight and monitoring.

<u>Funds derived from the beneficiary's assets, or from the receipt of gifts deposited into an ABLE account are exempt as income and resources under NYCRR §352</u>. Such transfers will shelter the beneficiary's assets for Medicaid and SSI purposes. However, monthly income of the beneficiary deposited into an ABLE account is not "exempt" for Medicaid or SSI purposes.

One useful feature of an ABLE account relates to payment of rent. The payment by parent (or trustee) for rent of the child will reduce the SSI payment by up to one-third. If the payment originates from an ABLE account, the SSI benefit would be unaffected. A parent wishing to utilize this technique could either make deposits into an ABLE account which would then make the qualified expenditure, or make a transfer to the SNT, which could then make a transfer to the ABLE account. Funds transferred from the SNT to the ABLE account will not count as income to the child. Social Security Administration's POMS SI 01130.740.

At death, the ABLE account must pay back to Medicaid an amount equal to the costs incurred by Medicaid since the ABLE account was established. This rule is more favorable than the payback rule for first party trusts which requires reimbursement for all costs paid by Medicaid during the lifetime of the disabled child.

XI. Conclusion

Third party special needs trusts enable parents and relatives to fund trusts which shelter assets so that their disabled child can qualify for Medicaid, SSI and means-tested governmental benefit programs without exhausting trust assets. Those trust assets can improve the child's quality of life by providing funds which can be used to pay for almost any expense other than food, shelter or an expense that would impair qualification for a government benefit.

When the child dies, remaining trust assets will benefit named trust beneficiaries. Care must be taken when implementing a third party trust for a minor, since the parent still has a legal obligation of support during the period of child's minority. Even so, the third party trust can likely serve other important purposes during the period when the child is under 18, one of which is being a receptacle for bequest made by perhaps grandparents, another of which relates to "waivered" government benefit programs that would not require Medicaid payback.

First party special needs trusts are a fallback, and may be used when a third party trust is not possible. This would be the case where the child has assets from a settled tort claim, or receives a direct bequest. First party trusts are funded not by parents or relatives but by the child himself. Since New York and nearly all other States do not permit a person to create an irrevocable, creditor-protected trust for his or her own benefit, a first party trust is possible only by virtue of the

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federal Medicaid statute which creates an exception for such trusts. The requirements for first party SNTs are more stringent than for third party SNTs, and the distribution requirements are more rigid. First party trusts must also "pay back" to Medicaid all funds expended by Medicaid during the child's lifetime when the trust terminates.

Both first and third party SNTs benefit from EPTL §7-1.2, which contains suggested language ensuring that the trust qualifies as an special needs trust. Various distribution options available only for third party trusts provide give added flexibility to the trustee with regard to discretionary distributions.

Special needs trusts in New York draw directly from the principles articulated by the Bronx Surrogates Court and affirmed by the Court of Appeals in *Matter of Escher,* a landmark case decided nearly fifty years ago, which held that a disabled person should not be required to exhaust his or her own assets before qualifying for government assistance:

> It is the conclusion of this court that the rigidity of any possible public policy requiring an invasion of trust corpus to relieve the burdens of a publicly funded program is subject to dilution, if it extends at all, in situations where the expenditure involved is the current astronomical cost of institutional care where the application of the total corpus to these charges would summarily render meaningless, a testamentary scheme, carefully designed to carry out an intent to retain some portion of a trust corpus for the ongoing needs of the life beneficiary, with a remainder for the benefit of other surviving issue. A contrary conclusion would, for almost all testators, except the most affluent, totally vitiate the viability of testamentary trusts as a device for bequeathing a remainder should the vicissitudes of life lead to an aged life beneficiary requiring extended institutional care.

Matter of Escher, 94 Misc.2d 952 (Surr.Ct., Bronx Cty 1978), *aff'd* 75 AD2d 531 (1st Dept. 1980). *aff'd* 52 NY2d 1006.

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