Trusts & Estates

Start Spreading the News: **Tax Issues** for **Expatriating** New Yorkers

BY DAVID PRATT, SCOTT A. BOWMAN AND MICHAEL ROSENBLUM

For an increasing number of New Yorkers, the decision to relocate to avoid onerous income and estate tax no longer stops at the city or state line. These taxpayers are going one step further.

Because the United States is the only country that taxes on the basis of citizenship, these taxpayers are considering saying "so long" to Uncle Sam, surrendering their U.S. citizenship, and "expatriating" to a new homeland. This article examines U.S. expatriation issues, particularly highlighting the tax consequences and recent Proposed Treasury Regulations, together with New York-specific considerations for those seeking to hail a taxi out of taxation.


BIGSTOCK

History of Expatriation Taxes

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the HEART Act) enacted Internal Revenue Code[1] (IRC) §§877A and 2801 to prevent avoidance of U.S. income and transfer taxation by certain U.S. citizens and residents (U.S. persons) who expatriate on or after June 17, 2008. Prior to the HEART Act, these U.S. expatriates were subject to an alternate tax regime under §§877 and 2107 for 10 years following expatriation. The new regime includes an "exit tax," which is an income tax, and the so-called "§2801 tax," which is a transfer tax.

Who Is Subject to These Taxes?

The current expatriation regime applies to "covered expatriates" (CEs) and those receiving transfers from CEs.

Unless an exception applies, a CE is a nonresident alien individual who relinquishes U.S. citizenship or ceases to be a long-term resident (a U.S. green card holder in eight or more of the prior 15 years) and who has (1) a net worth of at least $2,000,000, (2) an average annual net income tax over the five years preceding expatriation of more than $160,000 (for 2015, indexed annually for inflation), or (3) failed to certify and substantiate U.S. tax compliance for the past five years.

Exceptions exist for individuals who (1) were dual citizens at birth, taxed as a resident of a foreign country, and have resided in the United States for less than 10 of the last 15 taxable years prior to expatriating, or (2) relinquish U.S. citizenship before age 18½ and have resided in the United States for less than 10 taxable years prior to expatriating.

The Exit Tax

Section 877A imposes a one-time income tax on CEs upon renouncing their U.S. citizenship or relinquishing their U.S. greencard. The exit tax is calculated by treating all of the CE's property as being sold for fair market value on the day prior to the expatriation date. Any realized gain on this deemed sale is recognized.

For purposes of computing the exit tax, assets are valued under general transfer tax valuation rules (i.e., fair market value on the date of transfer). IRS guidance also provides that the transfer tax special valuation rules (i.e., Chapter 14 of the Code—§§2701 through 2704) apply as if the CE were transferring property to family members. Currently, valuation discounts for lack of marketability discounts, lack of control, or fractional interests should apply.[2] Accordingly, traditional estate planning techniques using such discounts may be implemented as part of pre-expatriation planning to reduce a CE's exit tax exposure.

A CE is permitted to exclude up to $690,000 of gain (for 2015, indexed annually for inflation). The exclusion is allocated pro rata among the expatriate's assets subject to the exit tax on the basis of the amount of gain recognized with respect to each asset. This pro rata allocation is intended to prevent the CE from allocating the exclusion amount to ordinary income assets and other assets taxed at higher rates, such as collectibles.

There are two important exceptions from the exit tax base for "eligible deferred compensation items" and for certain "tax deferred accounts." Rather than being subject to the exit tax, eligible deferred compensation items are subject to 30 percent withholding at the source of payment on the "taxable payment," meaning any payment to the extent it would be includible in the gross income of the CE if such expatriate continued to be subject to tax as a U.S. citizen or resident. The exit tax also provides that "tax deferred accounts," such as individual retirement accounts and tax-preferred education and medical savings accounts, are treated as being distributed in their entirety to the CE on the expatriation date. No early distribution taxes apply.

Because the deemed gain triggered by the exit tax will not have corresponding liquidity, deferral of the tax payment is permitted, subject to an interest charge. If the CE so elects, the pro rata portion of the exit tax associated with a particular asset can be deferred until actual disposition. As part of the election, the CE is required to provide "adequate security" for payment of the tax, which generally means a bond conditioned on the tax payment. Any CE making the election must also irrevocably waive any rights under any U.S. income tax treaty with respect to the collection of the exit tax. The liquidity issues associated with expatriation are often difficult ones, as CEs rarely wish to continue ties with the IRS during the deferral period, but may lack the liquidity to make an immediate tax payment.

The §2801 Tax

Section 2801(a) taxes U.S. persons receiving, directly or indirectly, an otherwise nontaxable gift or bequest in excess of the gift tax annual exclusion (currently $14,000) from a CE (a "covered transfer"), unless a charitable or marital deduction would have been available had the expatriate been a U.S. person. Whether the CE acquired the transferred property before or after expatriation is irrelevant. The §2801 tax is imposed at the highest estate or gift tax rate on the date of receipt (currently 40 percent), with a credit for any foreign estate or gift taxes.

Section 2801 treats domestic trusts as U.S. citizens, so domestic trusts receiving covered transfers are liable for the §2801 tax. A foreign trust that elects to be treated as a domestic trust for §2801 purposes (an electing foreign trust or EFT) must also pay §2801 tax directly. Foreign trusts that do not make this election (non-electing foreign trusts or NEFTs) are treated as non-U.S. persons, and distributions from a NEFT to a U.S. person triggers the §2801 tax.

Pursuant to Notice 2009-85, payment of the §2801 tax is deferred until the issuance of final guidance by the IRS. The Treasury Department has recently promulgated Proposed Regulations, providing some insight into the proper application of the §2801 tax regime.

Proposed §2801 Regulations

Section 2801 Tax Exceptions. The Proposed Regulations provide five exceptions to covered transfers: (1) taxable gifts timely reported and paid on a gift tax return (Form 709), (2) gross estate property timely reported and paid (including QDOT distributions) on an estate tax return (Form 706), (3) normally deductible charitable transfers, (4) normally deductible marital transfers including QTIP and QDOT assets if valid elections are made and (5) qualified disclaimers.

Indirect Transfers. The Proposed Regulations list five types of indirect transfers that trigger §2801 tax: (1) acquisitions by a business association (i.e., a corporation or partnership) owned by the U.S. person (but only to the extent of the ownership interest), (2) acquisitions by an entity not subject to §2801 tax on behalf of a U.S. person, (3) transfers by a CE to satisfy debts or liabilities of a U.S. person, regardless of the payee, (4) transfers resulting from a non-CE's power of appointment granted by a CE over property not in trust, and (5) "other transfers" not made directly by the CE to a U.S. person (a catch-all).

Foreign Trust Intermediaries. Section 28.2801-2(e) specifically includes as a "U.S. recipient" any U.S. person receiving a distribution from a NEFT if the distributions are attributable to covered transfers to the NEFT. Sections 28.2801-2(f) and (g) further confirm that such a distribution is a covered transfer if attributable to a transfer made to the NEFT. Under §28.2801-3(d), however, EFTs are not "looked through" to assess the status of beneficiaries; because EFTs are liable for the §2801 tax upon receipt of property from the CE, there will be no covered transfer upon distribution of such assets to U.S. beneficiaries.

Special Rules for Foreign Trusts. Section 28.2801-5 governs the applica- » Page 10

DAVID PRATT *is a partner at Proskauer Rose and the chair of the private client services department.* SCOTT A. BOWMAN *is a partner, and* MICHAEL ROSENBLUM *is an associate, in the department.*

2015's Top **Lessons**, **Developments**, And **Reminders**

BY SHARON L. KLEIN

From new legislation, to important regulatory guidance to instructive case law, 2015 saw some significant New York developments, lessons and reminders.

10. Clarifications Made to Act Regarding Adult Guardianship. The Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act[1] addresses the issue of jurisdiction over adult guardianships and other protective proceedings, providing a mechanism for resolving multistate jurisdictional disputes. The Act also specifies procedures for transferring guardianships to New York from other state courts and vice versa, provides a framework for judges in different states to communicate with each other and outlines procedures for cooperation between state courts. It is modeled after an act promulgated by the Uniform Law Commission, which has now been adopted in 43 jurisdictions. It went into effect in New York on April 21, 2014.

In addition to technical clarifying amendments, revisions enacted on Nov. 20, 2015[2] make clear that an adult guardian appointed in another state, if authorized to do so by the appointing court, can appear in New York courts and is authorized to sell real estate. The guardian can use the same process as New York appointed guardians, without having to go through a duplicative New York guardianship process.

9. New York City Revises Reporting Requirements for Partnerships and LLCs Acquiring Real Estate. When real property is transferred in New York City, the City requires Form NYC-RPT—Real Property Transfer Tax Return to be filed using its Automated City Register Information System (ACRIS). The form requires information about the "Grantor" and "Grantee." Effective May 18, 2015, Form NYC-RPT was revised to include two additional Grantor and Grantee types—"Single Member LLC" and "Multiple Member LLC." For any Grantor and Grantee that is a partnership or multiple-member LLC, the revised form requires the name and social security number or employer identification number for each general partner or member. If social security numbers or employer identification numbers are not provided, an affidavit must be filed attesting to the reasons the information is missing. According to the Department of Finance, the information will be "used for tax administration purposes and is confidential."

8. Court Explores Impact of Spousal Right of Election. In *Matter of Priedits*,[3] the court tackled questions relating to the estate tax payment and beneficiaries' ratable contributions when a surviving spouse elects against a will.

In *Priedits*, the decedent did not provide for his wife under his will, but she was named beneficiary of two IRAs. The decedent made several bequests to friends, with the residue of his estate passing to charity. The tax clause provided that all taxes be borne by the residue, including taxes apportioned against non-probate assets and preresiduary bequests. The wife was a non-U.S. citizen, and when she elected against the will, her interest was taxable. She relied on the tax clause to claim that she was not responsible for the taxes attributable to her elective share. The question before the court was whether the wife forfeited the benefit of the tax clause when she elected against the will.

Based on statutory construction, Surrogate John M. Czygier Jr. determined that the wife was entitled to the benefit of the estate tax provision, despite her election. He observed that the right of election does not provide that spouses forfeit every benefit they are afforded when they elect. In affirming, the Second Department noted that Estates, Powers and Trusts Law (EPTL) §2-1.8[c] provides that estate taxes must be equitably apportioned, unless otherwise provided. The court held that the tax clause in the decedent's will clearly and unambiguously reflected the decedent's intent that his preresiduary and nontestamentary beneficiaries, including his surviving spouse, were to take their property without liability for the payment of estate taxes. Whether the same result would have followed had the tax clause not been as broad is unclear.

The second question addressed by the court involved how the ratable contribution to the elective share is determined. While EPTL §5-1.1-A(c)(2) provides that the elective share must be paid ratably by the decedent's other beneficiaries, it is unclear from the statute whether the ratable contribution is computed based on the value of the estate gross or net of estate taxes. If the charitable residuary beneficiary, against which all the estate taxes were apportioned, was required to contribute before estate taxes were deducted, a much larger contribution would have been required. The Surrogate determined that it was proper to calculate the beneficiary's pro rata contribution to the elective share before estate taxes were deducted from the net elective share estate. The appellate court upheld. Query what result would ensue if a pre-tax contribution analysis resulted in a beneficiary being liable to contribute more than it received?

BIGSTOCK

In addition to technical clarifying amendments, revisions make clear that **an adult guardian appointed in another state,** if authorized to do so by the appointing court, can appear in New York courts and is authorized to sell real estate.

7. Estate Planning Documents Should be Revisited in Event of Divorce or Separation: Lesson & Reminder. EPTL §5-1.4 provides that divorce revokes dispositions to, and fiduciary nominations of, former spouses. In *Matter of Leyton*,[4] affirmed by the First Department on Jan. 5, 2016,[5] the decedent's mother and sister sought to disqualify the decedent's former same-sex partner as executor and a beneficiary under the decedent's will. They argued that he was the equivalent » Page 12

SHARON L. KLEIN *is managing director of family office services and wealth strategies at Wilmington Trust, N.A. in New York. The author thanks colleague* REBECCA LOMAZOW *for her valuable contribution to this article.*

Trusts and Estates Lawyers Face **Increasing Risks** of **Malpractice** Claims

BY WILLIAM T. McCAFFERY

Trusts and estates practitioners have long felt insulated from the reach of legal malpractice claims, in part due to New York's long-standing strict privity requirement.

However, the continued erosion of New York's strict privity requirement along with statistical evidence demonstrating the incremental increase in the number of malpractice claims against trusts and estates practitioners across the country may give the New York trusts and estates practitioner reason to review her professional liability insurance policy and exercise heightened caution in her daily practice.

Nationally, trusts and estates is the area of practice that results in the fourth highest number of legal malpractice claims. According to the American Bar Association Standing Committee on Lawyers' Professional Liability's 2011 study of national legal malpractice claims (the most recent study from which data is available), estates, trusts and probate accounted for 10.67 percent of all legal malpractice claims. Real estate was first with 20.33 percent of all claims; personal injury (plaintiff) was second with 15.59 percent of all malpractice claims; and family law was third with 12.14 percent of all claims.

While the trusts and estates practice area accounted for only 10.67 percent of all legal malpractice claims (nationally), what is important to note is the overall incremental increase in claims against trusts and estates practitioners occurring over the course of the 26 years between the American Bar Association Standing Committee on Lawyers' Professional Liability's first study of national legal malpractice claims and its most recent study. The American Bar Association Standing Committee on Lawyers' Professional Liability conducted its first study in 1985. In 1985, estates, trusts and probate claims accounted for only 6.97 percent of all legal malpractice claims. That number rose to 7.59 percent of all legal malpractice claims in 1995; to 8.67 percent in 1999; plateaued at 8.63 percent in 2003; and finally rose to 10.67 percent in 2011 (the most recent study). Based upon these figures, claims against trusts and estates attorneys have risen by more than 50 percent over the course of the past 26 years.

Not only have claims against trusts and estates attorneys risen nationally, but New York, a state that once prided itself on its very strict privity requirement, has also incrementally eroded its strict privity requirement in recent years, which has increased the potential for legal malpractice claims against the New York trusts and estates practitioner. » Page 14

WILLIAM T. McCAFFERY *practices legal malpractice defense at L'Abbate, Balkan, Colavita & Contini in Garden City.*

Roadblock in New **'Highway Bill'** Complicates Estate Administration

BY STACEY DELICH-GOULD AND HANNAH W. MENSCH

On July 31, 2015, the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[1] (the Act) was enacted into law.

The Act will change the process of estate administration by implementing new information reporting requirements for executors of estates as well as new basis consistency requirements for beneficiaries of inherited assets. Effective immediately, executors of estates must supply information statements to the IRS and to estate beneficiaries about the value of estate property. In addition, beneficiaries of such estates will generally be required to use the finally determined estate tax values as the income tax basis of property acquired from a decedent, and will no longer be able to claim that the fair market value of an asset on a decedent's date of death was greater than the value used for estate tax purposes.

Background

Under §1014(a)(1),[2] the "basis of property in the hands of any person acquiring the property from a decedent or to whom the property passed from a decedent" is the fair market value of the property at the date of the decedent's death.[3] This is commonly referred to as getting a "step-up" in basis at death.

New §1014(f). The Act added new §1014(f), which provides rules requiring that the basis of certain property acquired from a decedent *may not exceed* the value of that property as "finally determined" (as that term is defined in the Act) for federal estate tax purposes, or if not finally determined, the value of that property as reported on a statement made under new §6035 (discussed below).[4] However, this rule regarding consistency only will be applicable to property where inclusion of such property in the gross estate increases the estate tax liability.[5]

New §6035. The Act also added new §6035, which imposes new reporting requirements with regard to the value of property included in a decedent's gross estate for federal estate tax purposes.

The executor of any estate required to file a return under §6018(a)[6] must furnish, both to the IRS and each estate beneficiary, a statement identifying the value of each interest in estate property as reported on the return and such other information with respect to such interest as the IRS prescribes.[7]

Each person required to file a return under §6018(b)[8] must supply, both to the IRS and each other person who holds a legal or beneficial interest in the property to which such return relates, a statement identifying the information described above.[9]

The required statements must be furnished at a time no later than the earlier of (1) the date which is 30 days after the date on which the return under §6018 was required to be filed (including extensions) or (2) the date which is 30 days after the date such return actually is filed.[10]

Additional Guidance. The Act applies to all property with respect to which a federal estate tax return was filed after the date of enactment (i.e., July 31, 2015), meaning that the statement requirements apply for all returns filed after July 31, 2015, even if the decedent died *before* July 31, 2015. For some estates, this would have meant that the statements would have been due already. However, Notice 2015-57[11] announced that *Feb. 29, 2016* would be the initial due date for each statement required by §6035. The Notice provides that "[t]his delay is to allow the Treasury Department and IRS to issue guidance implementing the reporting requirements under §6035."

At the ABA Tax Section Meeting in September 2015, Treasury officials indicated that they hoped guidance would be issued by the end of January 2016 to help taxpayers and practitioners to comply with new §§1041(f) and 6035. On Dec. 18, 2015, the IRS published draft Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent" (Form 8971),[12] which is the required format for executors to comply with the Act. Draft instructions for Form 8971 (the "instructions") appeared on the website for the Office of Information and Regulatory Affairs the week of Jan. 4, 2016.[13]

Even with the publication of draft Form 8971 and accompanying instructions, there are many unanswered questions regarding the Act. The remainder of this article will detail what New York practitioners, executors and beneficiaries need to know, both in terms of how to comply with the Act and open issues that need consideration.

What Executors Need to Know

When are you required to furnish valuation statements? The general rule under §6035 is that if an estate is required to file a federal estate tax return under §6018(a), then the executor must provide a valuation statement to both the IRS (an "information return") and each of the estate beneficiaries ("beneficiary statements") no later than 30 days after the return's due date including extensions (or, if earlier, 30 days after the return is filed). Section 6018(a)(1) specifically provides that an estate tax return is required to be filed when the value of the decedent's gross estate *exceeds* the basic exclusion amount.

What format does the notice need to take? Although it is only an early release draft as of the date this article was submitted for publication, Form 8971 is the form of notice executors must use.

The front page of Form 8971 provides a format for the "information return" required by §6035. It instructs the executor to list information regarding the decedent and the executor along with certain beneficiary information (i.e., taxpayer ID number, address and date of service).

Schedule A of Form 8971 is the "beneficiary statement" required by §6035. The executor must complete a separate Schedule A for each beneficiary and include the following information: a description of the property acquired, whether the asset increased estate tax liability, the valuation date and the estate tax value.

Form 8971 and the instructions both provide that although the entire form (including each Schedule A) must be filed with the IRS, *only* Schedule A should be provided to each beneficiary in order to "protect privacy."

Who needs to receive the notice? Generally, the IRS and each beneficiary receiving property from the estate need to receive Form 8971 and/or Schedule A.

According to the Form 8971 instructions, if an executor is receiving property, the executor is required to send Schedule A to himself/herself. In addition, it is sufficient to provide Schedule A to just one trustee/executor if the beneficiary is a trust/estate. Schedule A can be furnished to beneficiaries in person or by email, U.S. mail, or private delivery service.

What about filings solely to make a GST allocation or to elect portability? The instructions provide that a Form 8971 does *not* need to be filed when an estate tax return is filed for the "sole purpose of making an allocation or election respecting the generation-skipping transfer tax."

However, the instructions do not offer a similar exception for estate tax returns filed for the sole purpose of electing portability. Based on the language of §6018(a)(1), if a return is filed for an estate below the basic exclusion amount in order to elect portability, it appears that Form 8971 need not be filed. However, due to certain ambiguities in the Treasury Regulations,[14] this conclusion is not certain, and the fact that the issue is not addressed in the instructions seems to indicate that Treasury officials are wrestling with this problem. Until the issue is clarified, it would be prudent to file Form 8971 for an estate filing a return only to elect portability.

What if the property being distributed does not increase the estate tax due? Section 1014(f)(2) provides a specific exception: The consistent basis regime *only* applies "to any property whose inclusion in the decedent's estate increased the liability" for the federal estate tax. Thus, if the estate is not subject to tax because of the marital or charitable deduction, then no asset in the estate would increase the liability for the estate tax, because there is no tax. The same applies to property that is received from an estate that, because of the basic exclusion amount, was not required to file an estate tax return. The estate beneficiaries would not be bound by the consistency in basis regime in these situations.

However, the executor is *still* required to furnish valuation statements to the IRS and estate beneficiaries under §6035(a). Form 8971 seems to confirm this will be the rule by providing a column on Schedule A where the executor must indicate whether the asset increased the estate tax value.

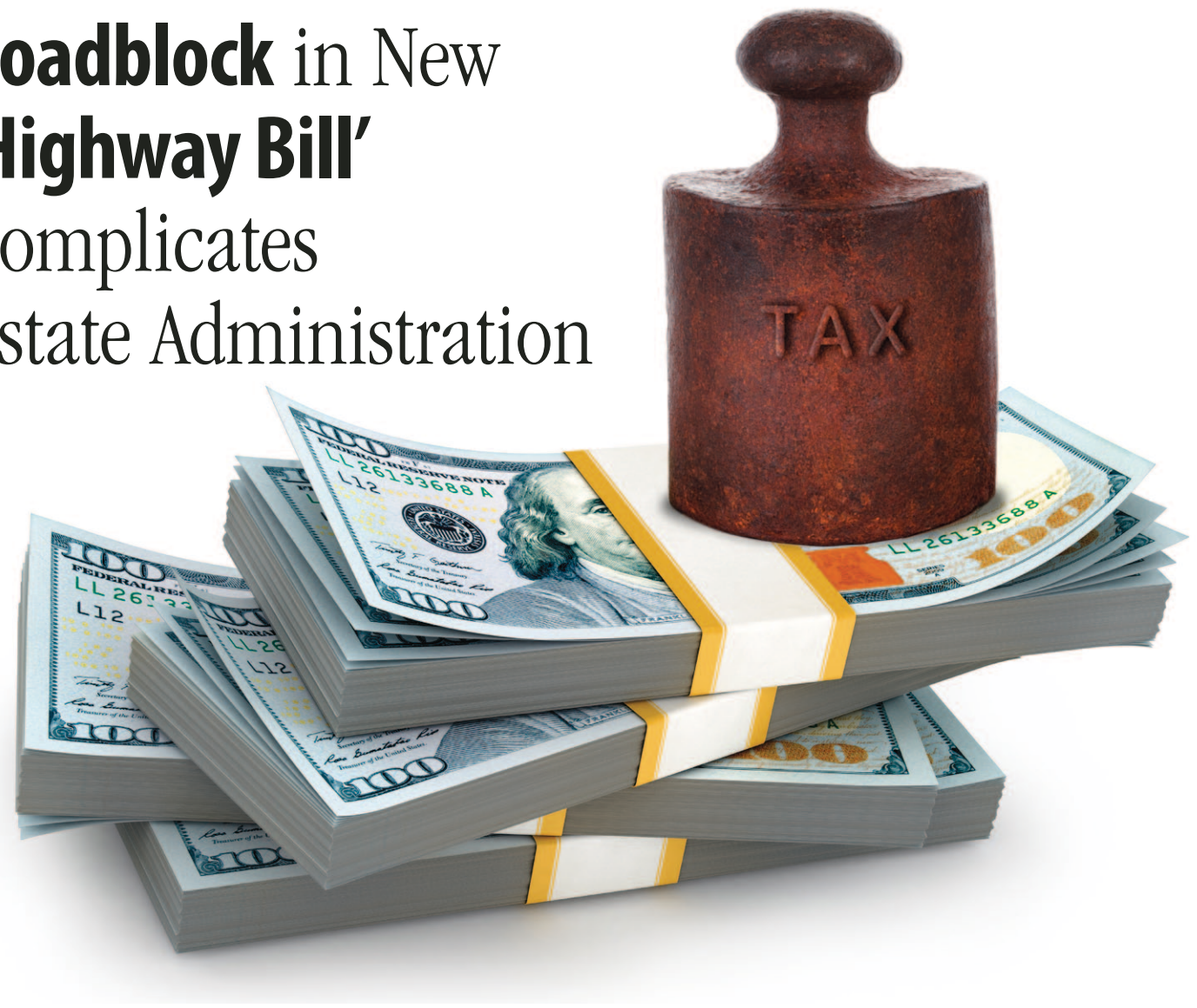
What if the executor does not have enough information? It is not unusual for an executor to file an estate tax return without having a full picture of the estate. For example, what if the executor cannot identify what specific assets will be distributed to beneficiaries within 30 days of the estate tax return filing? This is a common situation when assets are being divided between a credit shelter trust and a marital trust.

The instructions stipulate that if an executor has not determined which beneficiary will receive an item of property by the due date for Form 8971, then the executor must list "all items that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A." The instructions go on to acknowledge that the result may be that the same item of property is reflected on more than one Schedule A. Finally, the instructions provide that a supplemental Form 8971 and Schedule A must be filed once the final distributions have been made.

What if a decedent or beneficiary does not have a TIN? The instructions provide that if the decedent did not have a social security number, then the executor must obtain one for the decedent by filing Form SS-5 with the local Social Security Administration office. However, the instructions offer no guidance in situations where a beneficiary receiving a Schedule A does not have a social security number, other than to advise (in at least two different places) that entering "none" or "unknown" will cause the form to be considered incomplete and may subject the executor to penalties.

What if the values change? If valuation adjust- » Page 13

STACEY DELICH-GOULD *is counsel at Venable and a member of its tax and wealth planning group.* HANNAH MENSCH *is a partner at Ehrenkranz Partners, where she specializes in estate planning.*



BIGSTOCK

Expatriating

« Continued from page 9

tion of the §2801 tax regime to NEFTs. Recognizing that a foreign trust can be funded by covered and non-covered contributions, §28.2801-5(c)(1) creates a "§2801 ratio" to determine the NEFT's covered and non-covered portions. The covered portion includes any covered transfer and any appreciation and income accrued as a result of such transfers. The §2801 ratio is determined as follows:

$$\frac{[(\text{Pre-Contribution FMV of Covered Portion of Trust}) \times (\text{Pre-Contribution §2801 Ratio})] + [\text{Current Contribution FMV Attributable to Covered Transfer}]}{(\text{Post-Contribution FMV of Trust})}$$

Section 28.2801-5(c)(1)(ii) directs that once §2801 tax is timely paid on undistributed foreign trust property, that property is no longer deemed to be from a covered transfer. If the foreign trustee or U.S. recipient is missing information necessary to perform the above calculation, the entire distribution is deemed attributable to a covered transfer (i.e., the §2801 ratio is 1 and the entire distribution is subject to the §2801 tax).

Section 28.2801-5(d) describes the mechanics of the election by which a foreign trust is treated as a domestic trust. The election subjects the EFT to the §2801 tax on (1) all covered transfers received by the trust that year and for future years in which the election remains effective and (2) the portion of the trust attributable to covered transfers in prior years. Because previously taxed covered transfers are removed from the determination of the covered portion of the trust under §28.2801-5(d)(2), upon election, the §2801 ratio of the EFT becomes zero until the election is terminated and a subsequent covered transfer is made. However, distributions in prior calendar years by the EFT remain subject to the previous §2801 ratio and taxable to the U.S. beneficiary.

A valid foreign trust election is effective as of January 1 of the calendar year for which the Form 708 on which the election is made is filed and remains effective until terminated pursuant to §28.2801-5(d)(5)(ii). If the NEFT received no covered transfers that year, the Form 708 on which the election is made must be filed by the 15th day of the sixth month of the calendar year following the close of the calendar year for which the election is made, but an automatic six-month extension is permitted by filing a Form 7004 before the Form 708 filing deadline. The election is automatically terminated if: (1) the foreign trust fails to timely file the Form 708 and pay any §2801 tax then due, or (2) fails to pay additional §2801 tax resulting from an "imperfect election." As with the election, the termination is effective for the entire year at issue. However, subsequent elections for a year in which a termination occurs are expressly allowed under §28.2801-5(d)(5)(iii). In addition, §28.2801-5(d)(6) outlines the procedure for disputes between the IRS and an EFT over the §2801 tax.

If a NEFT migrates and actually becomes a domestic trust, the trust must timely file a Form 708 for the year of migration and pay any §2801 tax due based on the same calculation as an EFT (i.e., on all covered transfers received by the trust during the year in which domestication occurs, as well as on the portion of the trust's value at the end of the year preceding the year of domestication attributable to all prior covered transfers). The filing must be made by the 15th day of the sixth month of the calendar year following the close of the calendar year in which the NEFT becomes a domestic trust.

Section 2801 Tax Responsibility. Section 28.2801-7(a) places the burden of ascertaining a taxpayer's obligations under the §2801 tax regime on the taxpayer, including determination of whether (1) the transferor is a CE and (2) a transfer is a covered transfer. The IRS has reserved the right to provide the taxpayer with information about the transferor to assist the taxpayer, which can only be relied on if the taxpayer has no knowledge or reason to know that such information is incorrect. Living expatriate donors who do not authorize disclosures to their U.S. recipients are deemed via rebuttable presumption to be CEs that have made a covered gift.

In limited circumstances, a taxpayer may file a protective Form 708 without payment to begin the §2801 tax assessment period if the taxpayer reasonably concludes after exercising due diligence that the transfer is not subject to the §2801 tax. The Proposed Regulations specifically advise that the mere absence of information is not a sufficient basis for a protective Form 708.

Escape From New York

As mentioned above, for New Yorkers, U.S. expatriation is only half the battle. Expatriates who are New York state, New York City, and/or Yonkers (collectively, NY) residents must also break NY residency and domicile, as an expatriate will remain generally[3] subject to NY income and estate taxes if he or she is either (1) a NY domiciliary or (2) maintains a permanent place of abode in NY for more than 11 months during the year and spends more than 183 days per year in NY.

Breaking NY residency will trigger a NY exit tax under NY Tax Law §639(a), which requires including in the NY resident period any gains, losses, deductions, or ordinary income portions of lump sum distributions not previously recognized under the taxpayer's method of accounting but which would be recognized in income under the accrual method of accounting on or before the last day of the residency period. The relative amounts of NY and federal exit taxes paid depends on the timing of expatriation and breaking of NY residency. A New Yorker who breaks NY residency and expatriates on the same date will pay federal and NY income taxes on the deemed sale of assets caused by the expatriation as that sale is treated as occurring on the day before the expatriation and so is treated as occurring during the residency period. A New Yorker who breaks NY residency prior to expatriating should not pay the NY exit tax on the deemed sale of assets caused by the expatriation, as those gains should not be treated as having accrued under the accrual method of accounting on or before breaking NY residency but of course will pay the federal exit tax on such deemed sale, i.e., gains that accrue before expatriation. A New Yorker who breaks NY residency after expatriating will not pay federal exit taxes on unrecognized gains accruing after the expatriation date but will pay NY exit tax on all such gains, to the extent they would be recognized under the accrual method of accounting on or before terminating NY residency.

Domicile: A New York State of Mind. Domicile is defined as the combination of physical presence in a place and the intent to remain there indefinitely. New York has a rigid set of auditing guidelines that are used to determine whether a person is a NY domiciliary.[4] The guidelines instruct the auditor to look first to four primary factors, then to a fifth secondary factor, and finally to a number of tertiary factors.

The first primary factor is the home; the auditor will evaluate and compare the use of any NY and non-NY residences. Second, the auditor will analyze any active business involvement, including patterns of employment, compensation sources, and active participation or substantial investment in NY businesses or entities. Third, the auditor will consider overall living patterns and time spent in NY. Fourth, the auditor will look to whether items "near and dear to the heart" are located in NY. If the first four factors are not dispositive, the location of close family members such as spouses and children are considered. Tertiary factors, considered only if a determination still cannot be made, include domicile citations in legal documents, primary mailing addresses for financial and family business correspondence, locations of safe deposit boxes, vehicle registrations and operator licenses, voter registration and history, parking tax exemptions, and telephone services.

Statutory Residency. An individual who is not a NY domiciliary will be considered to be a statutory NY resident (for income tax purposes) if they maintain a permanent place of abode (a PPA) in NY for more than 11 months during the year and spend more than 183 days per year in NY. A PPA is a permanent structure where a person can live year round, and includes residences owned or leased by spouses. Simply contributing toward expenses of a PPA can be considered residency-triggering maintenance. Spending a single minute in NY counts as a "day" for the 183-day rule, unless (1) travelling through NY to reach another destination or (2) a medical emergency requires presence in NY.

Exceptions. NY will apply the above statutory residency test without regard to any treaties or federal rules bearing on an expatriate's residency status for federal income tax purposes. However, because the starting point of NY taxation is federal gross income, an expatriate who under the IRC or a treaty is a nonresident alien for federal income tax purposes will not be subject to NY taxation on foreign source income.

A NY domiciliary will not be a NY resident if he or she falls under either of the following three-factor state law exceptions. To qualify for the first exception, the domiciliary must, (1) not have maintained a NY PPA during the year, (2) have maintained a non-NY PPA during the *entire* tax year and (3) have spent 30 days or less in NY during the tax year. To qualify for the second exception, the domiciliary must (1) be in a foreign country for at least 450 days during any 548 consecutive day period, (2) have spent 90 days or less in NY (spouses and minor children count as the domiciliary for this test), and (3) have spent no more days in NY than as permitted under the following formula:

$$\text{Maximum Number of Days Allowed in NY} = 90 \times \frac{\text{Number of Actual Foreign Days in 548 Day Period}}{548}$$

Conclusion

While the combination of hefty city, state, and federal taxes have many New Yorkers' vagabond shoes longing to stray, a "clumsy" expatriation will cause a big bite to be taken out of their big apple. Leave the concrete jungle with caution … and counsel!

1. Unless otherwise noted, all citations are to the Internal Revenue Code of 1986, as amended, and to currently Proposed Treasury Regulations promulgated thereunder.

2. It is anticipated that Treasury Regulations under § 2704 will be issued in the near future. Such regulations would likely impact the applicability of discount planning. A discussion of these regulations is beyond the scope of this article.

3. Note that a nonresident of NY will remain subject to NY income tax on any so called "NY source income" and a nonresident's estate will be subject to NY estate tax on any real or tangible personal property located in NY upon death. Similarly, a U.S. expatriate will still be subject to federal income tax on "U.S. source income" and such individual's estate will be subject to federal estate tax on any real or tangible personal property located in the United States upon death. Analysis of these situs-based rules is complex and beyond the scope of this article.

4. The guidelines are available at http://www.tax.ny.gov/pdf/2014/misc/nonresident_audit_guidelines_2014.pdf.

Protecting Pets With Estate Planning

BY TERENCE E. SMOLEV AND CHRISTINA JONATHAN

While you were shopping for the holidays this year, you may have noticed more and more people walking the busy aisles cradling their puppies instead of babies. The trend is also seemingly popular in banks, which have replaced lollipops for dog treats in some branches.

Whether these beloved pets are in lieu of children, or are simply loyal companions, it is no doubt that pets have become an integral part of many families. This new family dynamic has led to changes in New York's estate laws over the years to ensure that pets are cared for upon their owners' demise.

Historically, pets were always considered property. Besides the traditional pets such as cats, dogs, birds, fish, etc., according to McKinney's Agriculture and Markets Law §108, a domestic animal is also any "domesticated sheep, horse, cattle, fallow deer, red deer, sika deer, whitetail deer which is raised under license from the department of environmental conservation, llama, goat, swine, fowl, duck, goose, swan, turkey, confined domestic hare or rabbit, pheasant or other bird which is raised in confinement under license from the state department of environmental conservation before release from captivity, except that the varieties of fowl commonly used for cock fights shall not be considered domestic animals for the purposes of this article."

BIGSTOCK

New York was among the early states that enacted a pet trust statute in 1996. Currently, there are 38 other states, as well as the District of Columbia, that have passed similar pet trust statutes.

Thus, as property, a person may bequeath his pet or domesticated animal in his last will and testament. However, as practitioners, we all know that a will does not necessarily guarantee that the testator's wishes will be carried through. Unfortunately, a will contest may leave a significant gap in time from when a testator passes away until one is actually appointed as a fiduciary of his estate. Thus, the fate of a pet will be left legally unprotected, unless the testator created a trust for the care and maintenance of his pet.

New York was among the early states that enacted a pet trust statute in 1996. Currently, there are 38 other states, as well as the District of Columbia, that have passed similar pet trust statutes. New York's Estates, Powers and Trusts Law (EPTL) §7-8.1 allows a grantor to create a trust for the care and maintenance of his beloved pet. This is a legally enforceable document, like any other trust. A trustee is designated therein, or if none, the court will appoint a trustee. The principal and income of the pet trust must be used for the benefit of the designated animal, unless expressly stated differently. Initially, by operation of law, the pet trust terminates when the animal dies, or at the end of 21 years, whichever is earlier. When the trust terminates, the corpus then gets distributed as directed by the trust, or if there are no directions therein, then it passes to the grantor's estate.

There has been much debate over the 21-year limitation within the statute. Although this time frame may be more than satisfactory for pet owners who have cats or dogs, it created a problem for animals with a longer life expectancy, such as horses or parrots. In addition, the 21-year limitation also caused problems for pet owners who have created an inter vivos pet trust. To illustrate this dilemma, suppose a pet owner becomes incapacitated and prior thereto executed an inter vivos pet trust for the care of his pet for 18 years before he passes away. Upon his death, by operation of law, the pet trust will terminate after three more years. Various committees, which are dedicated to the protection of animals, petitioned to amend EPTL's §7-8.1 time frame to cure this problem. As a result, on May 5, 2010, the legislature eliminated the 21-year restriction to allow the trust to last for the entire life span of the animal.[1]

Although a pet may be protected for its entire lifespan, this does not necessarily protect said pet from a bitter relative because, like any other trust, a pet trust may be contested. For example, a petitioner may bring an accounting proceeding against the trustee, may petition to remove a trustee, or even move to invalidate the pet trust for a grantor's lack of capacity. The most monumental contested case regarding a disposition to an animal is that of the late real-estate tycoon Leona Helmsley.

According to ABC news, Helmsley was nicknamed "the Queen of Mean," for cutting off her grandchildren and instead providing the bulk of her assets to her dog.[2] Helmsley's pet dog, Trouble, became a super-star as the world's richest dog upon Helmsley's demise. She left Trouble $12 million dollars in trust so that the dog may maintain its extravagant lifestyle including thousands of dollars in routine dog grooming, gourmet dog food and around the clock security guards.

It is no surprise that litigation followed after Helmsley's will became known. As a result, her pet trust was reduced from $12 million to $2 million. The judge held that Helmsley's trust was overfunded for the carrying out of the decedent's wishes. The court did not adjust the trust principal to interfere with Helmsley's desire to care for her pet. Rather, the trust principal was reduced because the disposition to the trust was greater than what was required to carry out her intentions.[3] The court also noted that judges are cognizant of preserving a testator's intent and will not disturb a trust unless factors are presented to legally invalidate the trust instrument. Nevertheless, we must advise our clients that when creating a pet trust, they should consider bequeathing like amounts to their human heirs; however, there is no requirement to do so.

In addition, we also have to advise our clients of the tax consequences of creating a pet trust. With an ordinary testamentary trust, as opposed to a pet trust, there is a designated beneficiary who is responsible for paying taxes on any income received by the trust. On the other hand, since the beneficiary of a pet trust is an animal, it does not fit within any definition of a "person" as defined in the Internal Revenue Code as someone responsible for taxes.

At first glance, it appears that based on the foregoing, the pet trust would be a means to avoid paying taxes. Unfortunately, to ensure taxes are paid to the government, the IRS held that in jurisdictions where pet trusts are valid, "it is subject to the imposition of the tax of section 1(d) of the Code pursuant to section 641 and no deductions are allowable for distributions under section 651 and 661."[4] Simply stated, the assets that are distributed pursuant to the pet trust are included as part of the decedent's gross taxable estate. No taxable deductions are allowed and no portion of these assets qualify for a charitable estate tax deduction, even if the remainderman is a qualifying charity.

Perhaps the IRS refused to amend or change its definition of "persons" to include pets, so as not to open Pandora's box. There are so many animal rights activists these days, including influential groups constantly trying to change legislation. Recently, an animals' rights group commenced litigation against Stony Brook University, quoting the provisions of EPTL's §7-8.1 to bolster their position that animals should be treated as persons.[5]

In that case, the petitioner filed several cases in various New York courts seeking legal rights for chimpanzees and ultimately other animals. The petitioner brought a proceeding pursuant to CPLR art. 70 and under common law for a writ of habeas corpus for the chimpanzees that were in the custody of the State University of New York at Stony Brook. Petitioner hoped for a "successful outcome here, given this state's recognition of legal personhood for some nonhuman animals under the EPTL, which expressly permits a "domestic or pet animal" to be designated as a beneficiary of a trust."[6] Needless to say, the petition was denied; however, the court issued an extensive opinion empathizing with petitioner's goals and even recognizing that some commentators have described the current legal status of animals as "quasi-persons, being recognized as holding some rights and protections."[7]

Our law has come a long way and has become more liberal with certain issues, including the recognition and protection of animals. We must remember to advise our clients accordingly, as some practitioners may forget to include provisions in testamentary documents for the care and maintenance of their clients' pets.

1. McKinney's E. P. T. L. §7-8.1, NY EST POW & TRST §7-8.1.
2. http://abcnews.go.com/US/leona-helmsleys-dog-trouble-richest-world-dies-12/story?id=13810168.
3. See *In re Copland*, 44 Misc.3d 485, 988 N.Y.S.2d 458, 2014 N.Y. Slip Op. 24172.
4. See Rev. Rul. 76-486.
5. Article 70 of CPLR for a Writ of Habeas Corpus, *The Matter of Nonhuman Rights Project v. Stanley*, 49 Misc.3d 746 (2015).
6. Id.
7. Id.

TERENCE E. SMOLEV *practices law at the Law Office of Terence E. Smolev, P.C.* CHRISTINA JONATHAN *is an associate of the firm.*

2015

« Continued from page 9

of a former spouse, disqualified from inheriting pursuant to EPTL §5-1.4. The decedent and his former partner had entered into a commitment ceremony in New York in 2002, but were separated before the decedent died.

Surrogate Nora Anderson determined that it is for the Legislature to decide matters regarding same-sex marriage, which New York did not recognize until 2011. Accordingly, the court could not retroactively apply the Marriage Equality Act to deem the commitment ceremony to have sanctified the marriage, so the parties could not be deemed divorced. The result was that the former partner, who had actually married another man before the decedent's death, was permitted to act as executor and inherit under the decedent's will. In affirming the decision, the appellate court also noted that, in order for EPTL §5-1.4's "former spouse" provision to apply, there must be a formal decree or judgment ending the marital relationship. No such decree was issued.

Matter of Lewis,[6] affirmed by the Court of Appeals on June 4, 2015,[7] provides a similar lesson. At issue in that case was the fact that EPTL §5-1.4 by its terms revokes dispositions to, and fiduciary nominations of, former spouses, but the revocatory effect of the section does not extend to the *relatives* of an ex-spouse.

In *Lewis*, the decedent executed a will many years prior to her divorce, leaving her entire estate to her then husband, who she also appointed as executor. Although EPTL §5-1.4 worked to revoke the disposition to, and fiduciary nomination of, the decedent's ex-husband, she had named her ex-husband's father as the alternate executor and alternate beneficiary of all her property. Even if the court assumed the ex-husband might someday inherit or obtain the property from his father, it determined that the statute is clear and unambiguous in omitting the relatives of an ex-spouse. The court held that the fiduciary appointment and beneficiary designation of the ex-father-in-law was valid.[8]

Note that, in those jurisdictions that have adopted the Uniform Probate Code, testamentary bequests to the former spouse's relatives, as well as bequests to the former spouse, are revoked.[9]

A proposal introduced in both houses[10] in New York embodies a middle ground: Dispositions to divorced spouses would continue to be expressly revoked, and there would be a rebuttable presumption that dispositions to relatives of an ex-spouse are revoked. Importantly, however, spouses who are in the *process* of getting divorced, but are not yet divorced, will not be able to rely on a statutory presumption under current law or under the new proposal.

And therein lies perhaps the most poignant lesson to draw from *Leyton* and *Lewis*: Do not rely on state default law at all. Divorced spouses, spouses in the process of getting a divorce and unmarried couples who are separated should give immediate attention to their planning documents, to ensure they reflect their intent.

6. Statutory Residency: Administrative Law Judge Issues Favorable Taxpayer Determination.

New York generally taxes residents on their worldwide income. There are two separate and independent bases on which an individual can be taxed as a resident: (1) the individual is domiciled in New York or (2) the individual is a nondomiciliary who satisfies the statutory residency test. That test has two prongs: The nondomiciliary must (a) maintain a permanent place of abode in New York *and* (b) spend more than 183 days in the state during the taxable year.[11]

The situation in *Matter of the Petition of David and Karen Sobotka*[12] involved a taxpayer who became domiciled in New York on Aug. 18, 2008 and was thus taxable as a resident for the period from Aug. 18 to Dec. 31, 2008. The Division of Taxation also determined that the taxpayer was a statutory resident, taxable for the whole year, based on the number of days that he spent in New York during 2008 in its entirety. The taxpayer argued that, because a statutory resident is defined as a nondomiciliary, the Division was precluded from counting the days in New York during which the taxpayer was a domiciliary.

The Administrative Law Judge determined that the taxpayer had to satisfy both the day count and the abode tests during the nondomiciliary period. Regarding the latter: "For purposes of determining statutory resident status during a portion of a given year, one may not count days that fall within the domicile-based resident portion of the same year." Accordingly, in the situation at hand, the taxpayer could be a statutory resident only if he spent over 183 days in New York before Aug. 18, which will be determined at a hearing.

Although the Administrative Law Judge's decision cannot be used as precedent, this ruling is very favorable to taxpayers, who might consider whether this analysis is helpful to their situation.

5. Disregarded Entities Owned by Nonresidents Will Not Shield Real Property from New York Estate Tax.

Under New York Tax Law §960, a nondomiciliary's real and personal New York situs property is subject to New York estate tax, but intangible personal property owned by a non-New York domiciliary is not subject to New York estate tax. In a recent Advisory Opinion,[13] a New York resident inquired about forming a single-member LLC under Delaware law for the "sole purpose" of contributing his New York condominium to the LLC and then moving to another state until his death. The question was whether the condominium would then be considered "intangible property" for New York estate tax purposes. The New York State Department of Taxation and Finance confirmed that it would treat the interest in the single-member LLC as real property for estate tax purposes. The basis for the Department's ruling was that a single-member LLC is a disregarded entity for federal income tax purposes, deemed not separate from its owner. This would cause the condominium owned by the LLC to be treated as real property held by the taxpayer and subject it to New York estate tax. This ruling is consistent with a prior Advisory Opinion[14] in which the Department distinguished between an interest in a single-member LLC holding New York real estate (includable in the gross estate) and New York real estate interests held in an S Corporation or a single-member LLC electing to be treated as a corporation under the check-the-box rules (treated as intangible property, provided there is also a business purpose).

> In computing the **New York taxable estate**, both resident and nonresident estates must exclude **any deductions that relate to property** which is not included in the New York gross estate.

However, a compelling memorandum submitted by the New York City Bar Association,[15] asserts that, in looking to federal income tax law to determine state estate tax liability, the Department reversed the proper order of analysis. Instead, state law should first determine the character of property rights, and tax law should then be applied based on the state law characterization. Under New York Limited Liability Company (LLC) Law §601, "A membership interest in the limited liability company is personal property. A member has no interest in specific property of the limited liability company." The New York City Bar Association has requested that the Department publish a revised Advisory Opinion confirming that an interest in a single-member LLC recognized under applicable state law would constitute intangible personal property pursuant to New York LLC Law §601 and therefore would not be subject to New York estate tax.

Whether the Department will issue a revised Advisory Opinion is yet to be seen. In the interim, however, it is clear that the Department's position is that real property held in a nonresident's single-member LLC/disregarded entity will be subject to New York estate tax at the nonresident owner's death. Advisors should consider whether a more complex entity structure would be appropriate given income, estate and other non-tax considerations, or whether the issue might be bypassed altogether if the nonresident opts instead to own shares in a cooperative apartment.

4. New York Issues Estate Tax Guidance for Residents and Nonresidents Owning New York Property.

The New York State Department of Taxation and Finance issued a Technical Services Bulletin (TSB) regarding the treatment of certain deductions for New York estate tax purposes.[16] The guidance applies to estates of individuals dying on or after April 1, 2014.

In computing the New York taxable estate, both resident and nonresident estates must exclude any deductions that relate to property which is not included in the New York gross estate. The TSB provides guidance regarding three categories of deductions: (1) Deductions directly related to real and tangible property, such as charitable deductions for the donation of land included in the gross estate and real or tangible property included as part of the marital deduction, (2) deductions directly related to intangible property, such as broker fees and stocks, bonds or cash included as part of the marital deduction, and (3) deductions indirectly related to real and tangible property or intangible property ("Indirect Expenses"), such as executor's commissions, accounting fees, attorney fees, funeral expenses and debts of the decedent. The TSB explains which deductions are disallowed, including how to apportion deductions in the third category—the Indirect Expenses.

The New York taxable estate of a resident includes intangible property and excludes real or tangible personal property located outside of New York. Accordingly, in computing the New York taxable estate of a resident, federal deductions that relate directly to real and tangible property located outside New York are disallowed, federal deductions that relate to intangible property are allowed and federal deductions that are indirectly related to property outside New York are disallowed by allocating Indirect Expenses. The allocation is computed by multiplying the Indirect Expenses by a fraction equal to (1) the value of real and tangible property located outside New York over (2) the value of the federal gross estate. For example, if half of the gross estate was real and tangible property located outside of New York, half of the executor's commissions would be disallowed as a deduction.

The New York taxable estate of a nonresident is computed in the same way as for a resident, but does not include intangible property. Accordingly, in computing the New York taxable estate of a nonresident, federal deductions that relate directly to real and tangible property located outside New York are disallowed, federal deductions that relate to intangible property are disallowed and federal deductions that are indirectly related to property outside New York are disallowed by allocating Indirect Expenses. The allocation is computed by multiplying the Indirect Expenses by a fraction equal to (1) the value of real and tangible property located outside New York plus intangible property over (2) the value of federal gross estate. The good news for nonresidents is that they seem to be permitted to deduct the balance of the Indirect Expenses—a fractional proportion of those expenses that are indirectly related to estate property, including executor's commissions and attorney fees. In fact, in an example given in the TSB, which posits a $45 million federal gross estate of a nonresident, with $25 million in New York real property, the deduction analysis actually results in a negative New York estate. The $25 million New York estate is reduced by a $25 million marital deduction for the real property; deductions directly related to the New York real property; and a portion of the Indirect Expenses—total allowable deductions for New York purposes being $25,646,712.

3. Legislature Enacts Gift Add-Back Clarifications, but Anomalies Remain.

As a result of 2014-15 Executive Budget changes, the New York gross estate of a deceased resident will be increased by the amount of any taxable gift made within three years of death, if the decedent was a New York resident at the time the gift was made and at the time of death.[17] The three-year look-back applied to gifts made before Jan. 1, 2019. As a result of an amendment this year, the gift add-back does not apply to estates of individuals dying on or after Jan. 1, 2019. This means that, even if a gift is made before Jan. 1, 2019, it will not be brought back into the estate if the donor dies after Jan. 1, 2019. It is unclear why the relevant date changed from the date of gift to the date of death.

The way last year's budgetary language was drafted, there appeared to be a lack of parity with the estate tax regime: Gifts by a New York resident of out-of-state real property or tangible personal property were not specifically excluded from the gift add-back, but out-of-state real and tangible property are specifically excluded from the New York gross estate for New York estate tax purposes. 2015-16 Executive Budget changes clarify that gifts are not added back to the gross estate if they consist of real or tangible property having a location outside New York.

However, a disparity in tax rates remains: Although New York estate taxes are generally deductible against the federal estate tax liability, the estate tax attributable to the gift add-back does not seem to be deductible under Internal Revenue Code §2058. The result is that gifts added back will potentially be subject to the full maximum 16 percent estate tax rate, without any offsetting federal deduction. An offsetting deduction against a 40 percent federal estate tax would reduce the effective tax rate from 16 percent to 9.6 percent. This disparity could lead to anomalous results: For example, if a New York resident gifted a New York residence within three years of death, the value of the residence would be added back to that individual's estate, and potentially subject to a 16 percent New York estate tax.

» Page 13

2015

« Continued from page 12

But if that same individual had died with that same New York residence, the New York estate tax would be deductible, reducing the effective tax rate to 9.6 percent.

2. 2014-2015 Budget Effects Dramatic Fiduciary Income Tax Changes: 2015 is First Year to Report Accumulated Income Distributions.

Dramatic changes to New York fiduciary income tax laws were effected with the Executive Budget for 2014-15.

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

The 2014-15 Executive Budget included changes to the taxation of resident trusts. While it does not impose a tax at the trust level, the new law does tax distributions of accumulated trust income to New York beneficiaries of these exempt resident trusts.[18] This new throwback tax applies to distributions of income accumulated in tax years beginning after Jan. 1, 2014. By definition, therefore, the first accumulated income distribution could only have been made in 2015, with income accumulated in 2014. Accordingly, trustees of exempt resident trusts will have reporting requirements in 2016 with respect to 2015 accumulation distributions to New York beneficiaries.

On Jan. 6, 2016 the New York Department of Taxation and Finance released 2015 Form IT-205-J—New York State Accumulation Distribution for Exempt Resident Trusts, and Instructions. Every exempt resident trust must file Form IT-205-J for any tax year in which it makes an accumulation distribution to a beneficiary who is a New York resident. Unless excepted, resident beneficiaries who received accumulation distributions from exempt resident trusts in 2015 will have to include the accumulation distribution in their 2015 New York adjusted gross income. The exempt resident trust must compute the allocation of accumulated income distributions for each resident beneficiary on Part 4 of the new form, and provide that information to each beneficiary for the beneficiary's filing purposes.

Notably, however, the form calculates the accumulated income distribution with reference to federal distributable net income (DNI). Capital gains generally are not included in federal DNI (except, for example, if the trust is a foreign trust for federal income tax purposes). Accordingly, with capital gains apparently not subject to the accumulation tax and a number of potential strategies to reduce or eliminate the tax on accumulated income, establishing an exempt resident trust in a jurisdiction like Delaware can still be a very effective strategy for New York residents.

Consider also that the foundation for trust taxation in New York is the creation of a trust by a *New York testator or grantor*.[19] Except for source income, New York will generally not tax trusts created by *nonresidents*.[20] Accordingly, for residents of other states, New York may be an attractive jurisdiction in which to consider creating trusts.

1. As New York Estate Tax Exclusion Amount Rises, Planning Becomes More Critical.

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

Since the cliff effect can be very dramatic, planning takes on increased importance. If an individual dies before April 1, 2016 with an estate valued at $3,125,000 (the amount of the exclusion), the estate will owe no New York tax. If instead that individual's estate is just $175,000 more at $3.3 million, the estate would pay New York estate tax of $210,000 because a $3.3 million estate exceeds 105 percent of the $3,125,000 exclusion amount and therefore loses the benefit of the exclusion entirely. Reducing the taxable estate with a $175,000 charitable bequest (or even throwing that amount in the garbage …) would result in a tax saving of $210,000 by pushing the estate value down to the exemption level. Some practitioners are drafting formulaically with charitable gifts to prevent the cliff effect.

For estates with a surviving spouse, portability—the ability of one spouse to pass the federal unused exemption amount to the survivor—is not currently available at the New York level. That means that New York's exclusion amount is a use-it-or-lose-it proposition, making it critical to take advantage of the exemption amounts of both spouses. If one spouse simply leaves all to the other, the exemption of the first to die is wasted and that may also push the survivor's estate over a cliff. For example: Assume spouses in New York each own assets worth $3 million and the first spouse to die leaves everything to the survivor. The survivor dies when the New York exemption amount is $5,250,000. The survivor's $6 million estate will have "fallen off the cliff," and New York estate taxes of $510,800 will be payable. Structuring the estate plan to take advantage of the exemption amount at the first death with trust planning, for example, so that each estate is under the cliff threshold, could potentially result in estate tax savings to heirs of over half a million dollars.

1. N.Y. Mental Hyg. Law Ch. 27, T. E, Art. 83
2. New York A.7596/S.5482 (2015).
3. 132 A.D.3d 769, 18 N.Y.S.3d 387, 2015 N.Y. Slip Op. 07508 (2d Dept. 2015).
4. *Matter of Mauricio Leyton, Deceased*, No. 2013-4842/A/B (Surrogate's Court, N.Y. Co , June 16, 2015), NYLJ 1202730202742 (June 23, 2015).
5. *In re Estate of Leyton*, — N.Y.S.3d — (2016), 2016 N.Y. Slip Op. 00020 (1st Dept. 2016).
6. *Matter of Lewis*, 114 A.D.3d 203, 978 N.Y.S.2d 527 (4th Dept. 2014).
7. *In re Estate of Lewis*, 25 N.Y.3d 456 (2015).
8. The case has been remanded to the Surrogate to determine if the decedent had revoked her will.
9. Uniform Probate Code §2-804 (1969, last amended 2010).
10. New York A.7638/S.5684 (2015).
11. N.Y. Tax Law §605(b)(1).
12. 2015 WL 5096196 (N.Y. Div. Tax. App. 2015).
13. Advisory Opinion TSB-A-15(1)M (May 29, 2015).
14. Advisory Opinion TSB-A-08(1)M (Oct. 24, 2008).
15. http://www2.nycbar.org/pdf/report/uploads/20073013-SMLLCTaxAdvisoryEstateGiftReportFINAL121015.pdf.
16. Technical Memorandum TSB-M-15(4)M (Oct. 27, 2015).
17. N.Y. Tax Law §954(a)(3).
18. N.Y. Tax Law §612(b)(40).
19. N.Y. Tax Law §618. See 20 NYCRR §§118.1, 105.23.
20. N.Y. Tax Law §§631, 633; instructions to 2015 N.Y. Form IT-205 at 2. See N.Y. Tax Bull. TB-IT-615 (Dec. 15, 2011), available at www.tax.ny.gov/pdf/tg_bulletins/pit/b11_615i.pdf).
21. N.Y. Tax Law §952(c)(2).
22. N.Y. Tax Law §952(c)(1).

Highway Bill

« Continued from page 10

ments are made after Form 8971 is filed, then a "supplemental statement" has to be filed within 30 days of the date of adjustment.[15] According to the instructions, the "Supplemental Filing" box at the top of Form 8971 and accompanying Schedule A should be checked and the form should be re-sent, reporting only the information that has changed. Only beneficiaries affected by the change(s) need to receive new Schedule As.

Will there be any exceptions for certain types of assets? While the Act does not exclude any class of assets from the reporting regime, the practical realities of estate administration seem to dictate that exceptions should exist. For example, if a beneficiary only receives cash or property that is considered income in respect of a decedent (such as certain retirement plan benefits and commercial annuities), it seems unnecessary for an executor to furnish an estate tax valuation statement, as there is no basis change for such items.

Bequests of tangibles may also pose issues for executors, in that oftentimes decedents make many specific bequests of tangible personal property (e.g., items of jewelry, furniture, etc.) or give away items of de minimis value (e.g., clothing, pots/pans, etc.). It is common practice to lump such items together and provide one value, however, it is unclear from the Act and Form 8971 and instructions whether this would be permitted.

What happens if you fail to comply with the act? The Act applies the "failure to file" penalties of §§6271 and 6722 to executors who fail to timely furnish Form 8971 and/or Schedule As. The instructions attempt to clarify how two separate penalty regimes will be applied in the context of the Act, and the penalties can be severe.

According to the instructions, if an executor fails to timely file a correct and complete Form 8971 and/or Schedule A with the IRS by the due date and reasonable cause is not shown, then §6721 penalties apply. A complete Form 8971 must include all Schedule As and only one penalty will apply to all failures relating to a single filing. However, each filing of a Form 8971 (including all Schedule As) is considered a separate filing, regardless of whether the filing is of an initial Form 8971 or a supplemental Form 8971. The penalty amount depends on when the correct forms are filed and the instructions provide a schedule of penalties.

A separate penalty under §6722 applies to failures to provide correct and complete Schedule As to beneficiaries by the due date. The penalties will be applied "for each Schedule A required to be provided," and the penalty amounts are listed in the instructions.

The instructions do not address situations where no estate tax is due and §1014(f) does not apply, but §6035 still requires the executor to file Form 8971. In this situation, no penalty would be imposed for failure to file the estate tax return itself because no tax is due. However, sever penalties could seemingly still be imposed for failure to file Form 8971 and Schedule As. This seems an illogical result that will hopefully be corrected through guidance.

What Beneficiaries Need to Know

When are you bound by the valuation statement? Any beneficiary who receives property "the inclusion of which in the decedent's estate increased the estate tax due" is bound by the values reported, and Schedule A of Form 8971 specifically notifies beneficiaries of this rule. However, the beneficiary is not subject to these new reporting requirements if the property received (1) qualifies for the marital or charitable deduction, (2) is received from an estate that was not required to file an estate tax return, or (3) is received from an estate in which an estate tax return was filed solely to elect portability.

Note that because the executor is still required to file Form 8971,[16] beneficiaries should be aware that the IRS will be in possession of this basis information. Even though the beneficiary is not required to use the consistent basis regime, the IRS may attempt to use this information in future transactions.

Furthermore, the Act currently provides no mechanism by which a beneficiary can contest the executor's valuation. Beneficiaries who wish to dispute a valuation may want to consider their options, especially if future guidance does not provide any recourse in this situation.

Are there any exceptions? Beneficiaries should be aware that the Code makes at least two exceptions where the income tax basis can be greater than the estate tax value. Specifically, basis following death can exceed the value reported on the estate tax return when a decedent dies owning (1) a partnership or limited liability company interest subject to debt[17] and/or (2) real property subject to non-recourse debt.[18] The Act does not address either of these circumstances, and guidance may correct this inconsistency.

What happens if you fail to comply? If a beneficiary claims a tax basis in excess of the basis reported under §1014(f), the Act provides that an accuracy-related penalty of 20 percent will be applied to the underpayment arising from this "inconsistent basis reporting.[19] The instructions clarify that this penalty may be imposed on any beneficiary who reports basis inconsistent with an amount shown on Schedule A.

Conclusion

While the issuance of Form 8971 and the instructions were helpful, many questions, issues and inconsistencies regarding the implementation of the Act remain unaddressed. Furthermore, Form 8971 and the instructions are only in draft form, and cannot be utilized or relied upon as definitive guidance. We hope that additional and more detailed guidance will provide the necessary clarification.

1. H.R. 3236, P.L. 114-41.
2. References to a section (§) herein are to a section of the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated, and references to the "Regulations" are to the Treasury Regulations promulgated thereunder.
3. Section 1014(a)(1).
4. Section 1014(f)(1).
5. Section 1014(f)(2).
6. Section 6018(a) ("Estate Tax Returns—Returns by Executor").
7. Section 6035(a)(1).
8. Section 6018(b) ("Estate Tax Returns—Returns by Beneficiaries").
9. Section 6035(a)(2).
10. Section 6035(a)(3)(A).
11. I.R.B. 2015-36 (Aug. 21, 2015).
12. See https://www.irs.gov/pub/irs-dft/f8971–dft.pdf.
13. As of the date this article was submitted for publication, the instructions were not published on the IRS website and could only be accessed using the following link: www.reginfo.gov/public/do/DownloadDocument?objectID=60262200.
14. See Treasury Regulation Section 20.2010-2(a)(1), whereby an estate that elects portability "will be considered" to be required to file a return under §6018(a) for purposes of the timely filing requirement to elect portability.
15. Section 6035(a)(3)(B).
16. See section 6035(a).
17. See Treasury Regulation §1.742-1.
18. See Treasury Regulation §20.2053-7.
19. Section 6662(b)(8) and 6662(k).

Malpractice

« Continued from page 9

In 1986, New York's strict privity requirement was clear and held:

> [A]bsent privity of contract, the simple omission by an attorney to prepare a new will or codicil naming a new beneficiary of some part of the decedent's estate does not, by itself, render the attorney liable to the alleged beneficiary [citations omitted]. As we recently noted, "privity remains a viable factor in legal malpractice cases in this State (sic)."[1]

In 1988, the Second Department reiterated New York's strict privity requirement and upheld it for lawyers, even though the Court of Appeals had diminished the strict privity requirement for accountants. In *Spivey v. Pulley*, the Second Department held:

> The well established rule in New York with respect to attorney malpractice is that absent fraud, collusion, malicious acts or other special circumstances, an attorney is not liable to third parties, not in privity, for harm caused by professional negligence [citations omitted]. Moreover, while the Court of Appeals … carved out a limited exception to the privity rule with respect to accountants, this court has repeatedly and recently declined to enlarge the application of this exception to professionals other than accountants [citations omitted].[2]

However, in 1992, the Court of Appeals expanded the diminished privity requirement for accountants to attorneys, holding:

> Although the defendants in many of the prior cases addressing the issue have been accountants, there is no reason to arbitrarily limit the potentially liable defendants to that class of professionals … . We now conclude that in circumstances such as these, a theoretical basis for liability against legal professionals can be presented.[3]

The court further stated: "Having concluded that legal professionals are not immune from liability in these cases…there must be a showing that there was either actual privity of contract between the parties or a relationship so close as to approach that of privity."[4]

In 2010, the Court of Appeals in the case, *Estate of Schneider v. Finmann*, further diminished the privity requirement stating, "we now hold that privity, or a relationship sufficiently approaching privity, exists between the personal representative of an estate and the estate planning attorney."[5]

Most recently, in September 2015, in a case where the trustees of a trust created by a decedent brought a legal malpractice action against that decedent's attorney, the Second Department, citing *Estate of Schneider*, held, "the trustee plaintiffs stand in a position analogous to that of the personal representative of an estate, and therefore, possess the requisite privity, or a relationship sufficiently approaching privity, to maintain an action alleging legal malpractice against the defendant."[6]

While New York has now given standing to the personal representative of an estate to bring a legal malpractice action against the decedent's attorney, New York has not gone so far as to allow beneficiaries of an estate to maintain a legal malpractice action against a decedent's attorney, as some other states have permitted,[7] but given the erosion of New York's strict privity requirement, the potential for the expansion of the class of potential plaintiffs against a trusts and estates practitioner cannot be ignored.

> **Effective client communication starts at the outset of a representation** with the retainer agreement or engagement letter and continues throughout the course of the representation until the termination of the representation.

Limiting Exposure

As claims against trusts and estates attorneys increase and the class of potential plaintiffs against trusts and estates attorneys expands, it is imperative that trusts and estates practitioners recognize potential liability and take steps to minimize their exposure. In order to minimize potential exposure, it may be helpful to understand the areas of the trusts and estates practice in which malpractice claims most commonly arise. According to Canadian legal malpractice insurance carrier, Lawyers' Professional Indemnity Company, 33 percent of all malpractice claims against trusts and estates attorneys are due to attorney-client communication errors; 25 percent of all claims arise from the attorney's inadequate investigation; 16 percent of all claims arise from errors of law made by the attorney; 8 percent of claims are time related errors; 8 percent arise from clerical errors; 6 percent arise from conflicts of interest; and other miscellaneous errors account for the balance of the legal malpractice claims brought against trusts and estates practitioners.

With one-third of claims against trusts and estates attorneys arising from errors in attorney-client communication, it is clear that the most effective way for the trusts and estates practitioner to limit her exposure to potential claims is through effective client communication. Generally, the most prudent way to effectively communicate with a client is to do so in writing. Communicating all significant developments and decisions throughout the course of a matter in writing can significantly diminish the possibility of a misunderstanding or miscommunication between the client and her attorney. With a writing, there is no ambiguity, no question, and no uncertainty; the matter at issue is clearly stated.

Effective client communication starts at the outset of a representation with the retainer agreement or engagement letter and continues throughout the course of the representation until the termination of the representation. In the case, *Hallman v. Kantor*,[8] a legal malpractice action arising from an attorney's representation of a co-executor of a decedent's estate was dismissed where a clearly written retainer agreement demonstrated the limited scope of the attorney's representation. To the contrary, in *Leffler v. Mills*,[9] dismissal was denied to an attorney hired to probate a decedent's estate, where the attorney could not conclusively demonstrate when his representation terminated. In Leffler, the Third Department specifically stated that "there does not appear to have been a formal substitution or withdrawal of counsel."[10] Had there been such clearly written documentation from the attorney to the client, memorializing the termination of the representation, the case might have been dismissed or possibly avoided altogether. Clearly, written documentation between attorney and client can be the most effective tool in assisting the trusts and estates practitioner to avoid unwanted and otherwise avoidable malpractice claims.

In addition to improvements in attorney-client communications, the statistics demonstrate that trusts and estates practitioners can further diminish their exposure to potential liability by ensuring that they conduct thorough investigation and discovery; that they do not dabble in areas of the law in which they are not well versed, which can often lead to errors of law; that they make routine use of diaries and calendars for all meaningful dates and deadlines, helping to avoid time related errors; and that they maintain and use a thorough conflict check system in their practice in order to avoid unnecessary claims arising from avoidable conflicts of interest.

While it is impossible for any attorney to fully insulate herself from potential legal malpractice claims and liability, given the national rise of claims against trusts and estates attorneys and the ever increasing pool of potential plaintiffs against trusts and estates practitioners in New York, it is wise for today's trust and estate attorneys to be vigilant in their own risk management practices as they continue their diligent representation of their trusts and estates clients.

1. *Rossi v. Boehner*, 116 A.D.2d 636, 637, 498 N.Y.S.2d 318 (2d Dep't 1986).
2. *Spivey v. Pulley*, 138 A.D.2d 563, 564, 526 N.Y.S.2d 145 (2d Dep't 1988).
3. *Prudential Ins. Co. of America v. Dewey, Ballantine, Bushby, Palmer & Wood*, 80 N.Y.2d 377, 381-82, 590 N.Y.S.2d 831, 605 N.E.2d 318 (1992).
4. Id. at 382.
5. *Estate of Schneider v. Finmann*, 15 N.Y.3d 306, 309, 907 N.Y.S.2d 119, 120, 933 N.E.2d 718, 720 (2010).
6. *Ianiro v. Bachman*, 131 A.D.3d 925, 926, 16 N.Y.S.3d 85, 86 (2d Dep't 2015).
7. *Walker v. Lawson*, 514 N.E.2d 629 (Ind. Ct. App. 1987).
8. 72 A.D.3d 895, 901 N.Y.S.2d 284 (2d Dep't 2010).
9. 285 A.D.2d 774, 729 N.Y.S.2d 196 (3d Dep't 2001).
10. 285 A.D.2d at 776-777, 729 N.Y.S.2d at 199.