Trusts&Estates

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

BY AMY F. ALTMAN AND KRISTIN BOOTH GLEN

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

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

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

WIKI (2)

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

Corcoran Litigation

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

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

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

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

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

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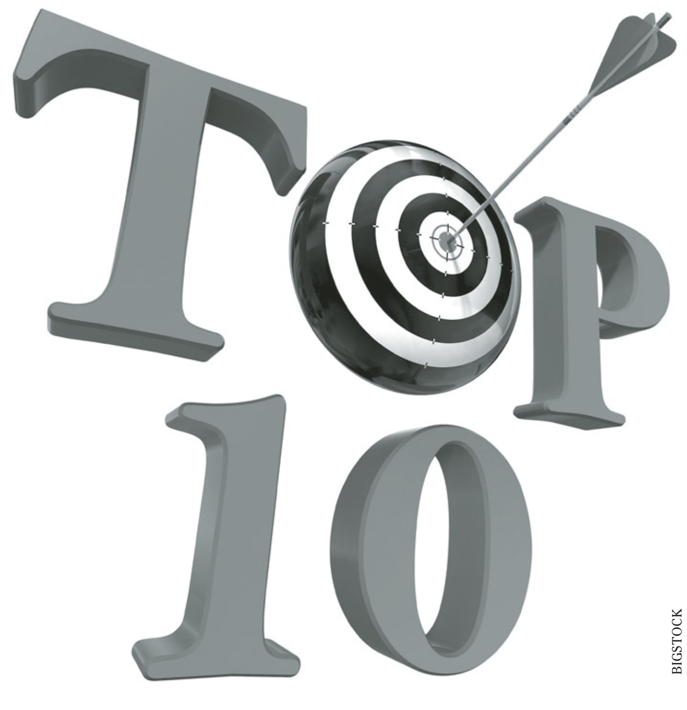

BIGSTOCK

Developments, Lessons And Reminders Of 2014

BY SHARON L. KLEIN

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Barnes Litigation

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

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

Who Is the Public?

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

Attorneys General

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

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

Relator Actions, Derivative Suits

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

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

Special Interest Doctrine

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

New York's Narrow Application

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

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

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

Conclusion

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

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

Bequest

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Contest Proof

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

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

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