Nassau Lawyer

THE JOURNAL OF THE NASSAU COUNTY BAR ASSOCIATION

December 2013 | www.nassaubar.org | Vol. 63, No. 4

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Of Note

NCBA Member Benefit – I.D. Card Photo
Obtain your photo for court identification cards at NCBA Tech Center. Cost $10.
January 21, 22 & 23 • 9 a.m. – 4 p.m.

Events

JOIN US TO CELEBRATE THE SEASON!
81st Annual Wassail Celebration
Thursday, December 12, 2013
6:00 p.m. at Domus
$20 pp/ children under 12 free
RSVP Special Events 516-747-4070

New York Islanders VIP Night
NY Islanders vs. Pittsburgh Penguins
Thursday, January 23, 2014
Nassau Coliseum
See Insert for Details

Nassau Academy of Law
Bridge the Gap
Saturday & Sunday, January 25-26, 2014
at Domus
See Insert and page 12-13

WE CARE
ARTrageous at the Bar
Art Show and Cocktail Party
Thursday, February 13, 2014
6:00 p.m. at Domus
See page 19

WE CARE
Children's Winter Festival
Wednesday, February 19, 2014
at Domus

NASSAU ACADEMY OF LAW
Hon. Elaine Jackson Stack
MOOT COURT Competition
Tuesday & Wednesday
March 25 & 26, 2014 at Domus
Details to follow

What's Inside

FOCUS: TAX LAW

IRS Disclosure of Protected Tax Data **Page 3**

Medicare Surtax on Investment Income: Analysis and Planning **Page 3**

"S" Corporations and the Built-in Gains Tax **Page 5**

The Conservation Easement Tax Incentive **Page 5**

Impact of *Windsor* on Federal Tax Law **Page 7**

The Tax Consequences of Income-Based Repayment of Student Loans **Page 9**

The GST Allocation Puzzle **Page 9**

Qualified Use in 1031 Exchanges **Page 11**

Tax Implications of Ownership Transfers **Page 11**

A View from the Bench
By Hon. Arthur M. Diamond **Page 14**

ANNUAL PRO BONO CAMPAIGN

Just One Billable Hour Can Make a Difference

Did you know that you can help 3,000 underserved residents of Nassau County have access to justice for the cost of one billable hour?

By Valerie Zurblis

Nassau County may be the third richest county in New York State, but there are thousands of residents living under the poverty level – homeless people, working poor, single parents with dependent children and the elderly. To protect their rights, access to the legal system is vital.

Fortunately, the Nassau County Bar Association partners with Nassau-Suffolk Law Services to support the Volunteer Lawyers Project (VLP). The VLP is a not-for-profit program that supplements the civil legal services provided by the Nassau-Suffolk Law Services staff with volunteer assistance from the Nassau County Bar Association.

In the past 12 months, VLP's services have benefitted more than 3,000 adults and children, with the active involvement of almost 200 pro bono attorneys. For the most part, these matters involve landlord/tenant (Attorney of the Day Project), bankruptcy and divorce cases. In addition, VLP hosts a free bankruptcy clinic every other month at the NCBA.

VLP is staffed by a full-time attorney, a part-time attorney and a full-time secretary. This small staff interviews and screens applicants for pro bono services, manages the recruiting of legal volunteers, directs the placement of pro bono cases, including follow up and final reporting of case dispositions and maintains the large client database.

This month all NCBA members should have received a letter asking you to participate in the Annual Pro Bono Campaign to help ensure the continued services of the Volunteer Lawyer Project. If you don't have the time to volunteer, know that a donation of what you charge for just one billable hour will go a long way to help all Nassau residents have access to justice. If you do not receive the mailing and would like to contribute to the Annual Pro Bono Campaign, please contact Elaine Leventhal (516) 747-4070.

Judicial Election Results

Hon. John M. Galasso
Hon. Hope S. Zimmerman
were elected to Supreme Court

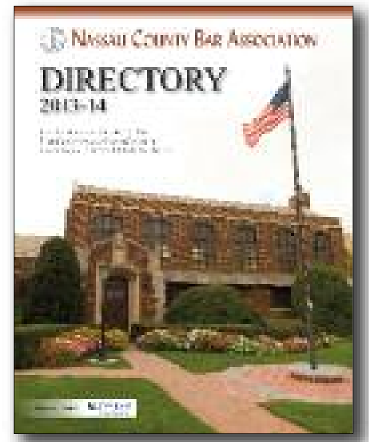
Hon. Patricia A. Harrington
Hon. David P. Sullivan
were elected to County Court

Hon. Scott H. Siller
Hon. Joy M. Watson
were elected to District Court

Hon. Rhonda E. Fischer
Hon. David Goodsell
Hon. Erica L. Prager
were re-elected to District Court

The Judicial Induction Ceremony will take place on
Monday, January 13, 2014
at 2:00 p.m.
Central Jury Courtroom
100 Supreme Court Drive
Mineola

For Induction Ceremony Information contact Dan Bagnuola at (516) 493-3262.



NCBA MEMBERS

YOUR 2013-2014 DIRECTORIES HAVE ARRIVED
Stop by Domus and pick-up your copy today!

When you attend a committee meeting, have lunch or are just stopping by – pick up your copy. The NCBA Directories will be available at Domus from 9:00 a.m. to 5:00 p.m.

Should a law firm wish to pick-up all of its NCBA member employees copies at one time, we are happy to coordinate with their messenger service. Firms should call the Membership Office to arrange time for pick-up.

Any directory that has not been picked up by December 24, 2013 will be mailed.

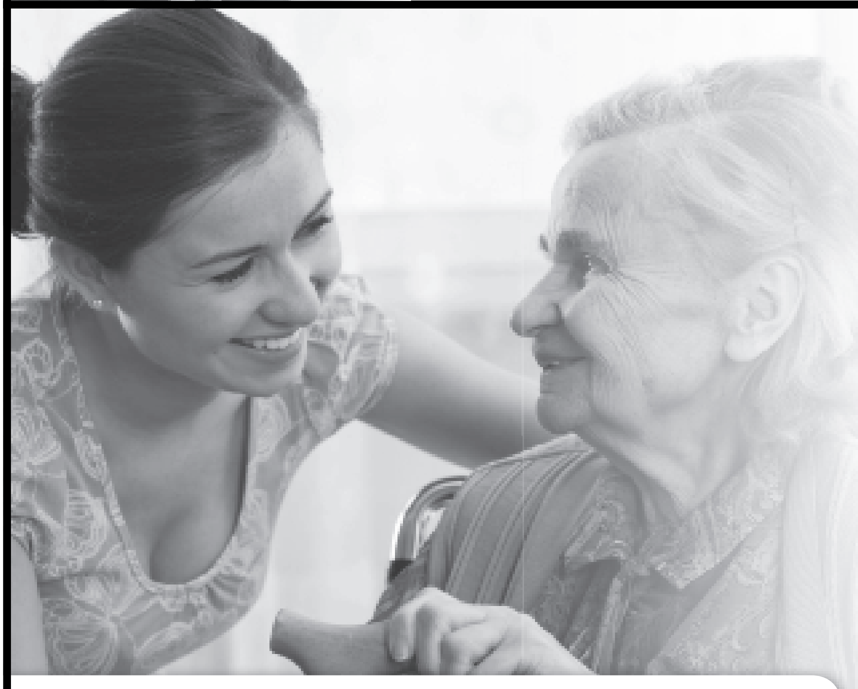
Upcoming Publications Committee Meetings

Thurs., January 9, 2014 • Thurs., February 13, 2014 – 12:45 at Domus

The Lawyer Assistance Program provides confidential help to lawyers and judges for alcoholism, drug abuse and mental health problems. Call 1-888-408-6222. Calls are completely confidential.

New Member Orientation
November 2013

Why *Refer* Your *Elder Law Case* To Vincent J. Russo and Associates?



Elder Law is a highly specialized practice area. The rules for guardianship, special needs trusts, qualification for Medicaid and Veteran's Aid & Attendance, home care and other strategies are complicated and full of pitfalls.

Seniors and their families are living longer in part due to healthier lifestyles and modern medicine. The challenge is that they are often out-living their money and even their ability to care for themselves.

Who will care for an elderly family member, pay for assisted living or nursing home care? Our attorneys can work with your clients and their families to resolve these issues.

We have a proven track record in helping seniors and their families plan effectively for their future.

Counselors to the Profession: Participation fees provided upon request, pursuant to DR-2-107

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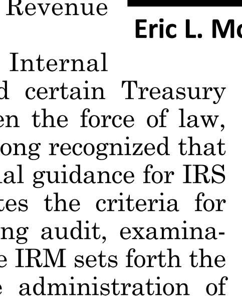
IRS Disclosure of Protected Tax Data

With all of the hype in the media about government dysfunction, the IRS has not been exempt from its own series of scandals.

In its recent past, it has been accused of wasting money, wrongfully disclosing taxpayer information and targeting specific political groups. And justifiably, many taxpayers are beginning to lose trust in "the system." But through these trials and tribulations, there was always a guidepost that taxpayers (and advisors) could rely upon to identify expected IRS Procedure when a controversy matter arises, namely the Internal Revenue Manual ("IRM").


Eric L. Morgenthal

Although the Internal Revenue Code (and certain Treasury Regulations) is given the force of law, Tax Advisors have long recognized that the IRM is the official guidance for IRS personnel. It dictates the criteria for IRS procedure during audit, examination and appeal. The IRM sets forth the parameters for the administration of tax, penalties and interest while providing a tangible delineation of IRS requirements and expectations.

As indicated in the IRM:

"The IRM is the primary, official source of IRS 'instructions to staff' that relate to the administration and operation of the Service. The IRM ensures that employees have the approved policy and guidance that they need to carry out their responsibilities in administering the tax laws or other agency obligations."[1]

The greatest benefit to the IRM is its transparency. The IRS employees are given marching orders to follow the IRM, and from its contents, taxpayers could decipher what to expect. They could also determine where their case results would resonate.

In order to understand how information can be disclosed and shared, a brief primer is first needed to explain how tax reporting of foreign income is governed. The Financial Crimes Enforcement Network ("FinCEN") is an agency that operates separately from IRS (yet still a part of the Department of the Treasury).

FinCEN processes and enforces the reporting of offshore financial data to protect against money laundering and terrorism. It handles Foreign Bank Account Reporting ("FBAR") matters and Title 31 of the US Code governs its guidelines. The FBAR form is a policing tool and can be obtained by other government agencies without need for prior authorization. On the other hand, the IRS is a separate component of the Department of the Treasury and is delegated to administer the nation's Income Tax laws. Its guidelines are instead governed under Title 26 of the US Code.

In the process of its pursuits, the IRS has begun to stray from the very rules it has established for itself.

Despite the existence of a common parent agency, it was understood that information filed with the IRS was private and information filed with FinCEN was, for the lack of better word, public. However as the US economy took a turn for the worse, the government decided it needed more money – a lot of money. It began looking in new places to identify additional sources of revenue, namely, by asserting high penalties for failure to report and disclose offshore accounts.

But in the process of its pursuits, the IRS has begun to stray from the very rules it has established for itself. The result has clouded the transparency of tax audits and risks the creation of additional taxpayer distrust. This past summer, the US General Accounting Office ("GAO") had suggested that Taxpayers who merely initiated "Quiet" voluntary disclosures (just mailing deficient tax filings outside of any Disclosure Program) and "first-time" filers be pursued via data mining.

There is a shortage of citable information with recent Foreign Account Disclosure Programs; particularly those associated with the recent "Loud" Disclosure submissions or "Quiet" Disclosure investigations. This had bolstered the importance of the IRM as a mechanism for navigating the unchartered waters of FBAR controversy matters, particularly for taxpayers who may now be pursued after the recommendations from the GAO.

However, due to the shared need for information, several questions emerge. Do the Income Tax Auditors require approval to pass your personal tax data along to FBAR Auditors? Can FinCEN obtain information for non-tax matters without authorization? Currently, there are information exchange arrangements between the IRS and the State tax authorities. But is it permissible for the IRS to pass that information to other federal agencies as well? And how closely would the income tax returns and/or IRS Income Tax Auditors findings be used as a basis for establishing willful conduct on FBAR violations?

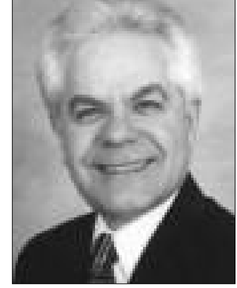
Congress has instituted provisions in the Internal Revenue Code that maintain the privacy of taxpayer data.[2] As a result, Income Tax Auditors are

See TAX DATA, Page 16

Medicare Surtax on Investment Income: Analysis and Planning

This article is not about Medicare. It's about a new 3.8% income tax[1] that you and your clients will pay beginning this year, 2013.

Welcome to the tax world of Alice in Wonderland – a place where we have never been and which is mysterious in so many ways. New Internal Revenue Code Section 1411 draws from many other areas of the IRC, but the IRS is reluctant to provide new definitions needed in order to apply the 3.8% surtax on net investment income. Come down the rabbit hole with me, and let's see what we find.


Alan E. Weiner

This "new" tax is not so new. It was enacted in 2010[2] as part of the Affordable Care Act to be effective for the first time this year, 2013. The IRS issued proposed regulations[3] on November 30, 2012 and we await final regulations which may have been issued by the time you read this article.

Let's begin by describing who is subject to the Net Investment Income Tax ("NIIT"), also referred to as the Medicare surtax.[4] An individual unmarried taxpayer is subject to the Medicare surtax when his/her Modified Adjusted Gross Income ("MAGI")[5] is greater than $200,000. A married couple is subject to the Medicare surtax when their MAGI is greater than $250,000. A same sex married couple whose marriage is recognized in the state in which they were married, and whose combined MAGI is greater than $250,000, will be subject to the Medicare surtax instead of being entitled to two-$200,000 thresholds. But as for estates and trusts, the threshold is significantly lower. For 2013, the threshold is $11,950 of taxable income and, because of the low threshold; estates and trusts easily will be subject to the 3.8% Medicare surtax.

If you expect to exceed the threshold applicable to you (or your client), keep reading.

What Is and Is Not "Net Investment Income"?

The tax is a tax on net investment income. We will get to deductions later.

The following items have been described as "buckets" (of investment income) subject to the 3.8% tax.

Bucket 1: Interest, dividends, capital gains, annuities, rents, royalties, etc. The gain on the sale of a principal residence is subject to the Medicare surtax only to the extent that the gain exceeds the IRC Section 121 principal residence exclusion (generally $250,000 for an unmarried individual and $500,000 for a married couple).

Bucket 2: Passive activity income. That is a tax "term of art." In its simplest form, it means income from an activity in which the taxpayer does not play an active role. For example, the taxpayer furnishes the money to a person (and becomes a partner or co-shareholder) in a business in which the money person is only an investor. Income generated by the taxpayer from this investment is 'passive income' and will be subject to the 3.8% tax. Also, in most cases, rental income is "passive income."

Bucket 3: Net gain that is attributable to the disposition of property (an interest in a limited liability company, a partnership, or an S corporation) unless the property is held in a non-passive activity trade or business. Without getting into the specifics, suffice it to say that a 'non-passive activity trade or business' is one

See SURTAX, Page 16

COUNTING OUR BLESSINGS

Last year, I had the privilege as president-elect of sharing the "true" tale of Wassail at our holiday celebration. As it turned out, the origins of Wassail bore a striking resemblance to the events depicted in the holiday classic, It's a Wonderful Life.

Fiction has often depicted how the world would be altered, for better or worse, if history were to be changed. The well-known premise of It's a Wonderful Life is that many lives are changed dramatically for the worse by the nonexistence of one good, caring person. Naturally, in my Wassail version of the story, I cast Past President Frank Yanelli in the Jimmy Stewart/George Bailey role because he epitomizes these qualities for me. And now, a year later, we join in mourning the loss of his beloved wife Roberta, who faced her extended illness with such dignity and courage.

FROM THE PRESIDENT

Peter J. Mancuso

Yet in our sadness, we also give thanks at this special time of year for all that is good in our personal and professional lives, including this wonderful Bar Association of ours. So, I thought that it might be interesting to look at our professional home through the prism of that classic holiday film: What if the Nassau County Bar Association had never existed?

Without our Bar Association, the attorneys who practice law in Nassau County never had the opportunities for professional growth presented by our substantive law committees. Our committees had been the backbone of our Bar Association, and without them we were spineless. Lost with them were endless opportunities for networking, legal education and developing social relationships in the collegial environment of Domus, well removed from the rough and tumble of the courtroom.

The many and varied educational opportunities offered by our Academy of Law were never available to attorneys in our community, to the great detriment of their clients. While there were other CLE providers, none were nearly as good or as economical as the $219 cost of the Domus Scholar Circle.

Our powerful voice in assuring the quality of our judiciary through the dedicated and time consuming work of our Judiciary Committee was forever silent. And there was no NCBA to protect our interests and those of the public by taking advocacy positions on legislation that affected us.

The 80 plus Mortgage Foreclosure free legal consultation clinics conducted by our Bar Association since the recession of 2008 never happened, with drastic consequences for many who lost their homes. Homeowners who were devastated by Superstorm Sandy never had volunteer attorneys to turn to for advice because there were no pro bono Superstorm Sandy Recovery clinics to help them in their time of greatest need. There also weren't any Pro Bono Legal Fairs for the community. Those who spoke English poorly or not at all found themselves particularly at risk, as there were no BOLD clinics or Language Line programs to ensure that language differences would not be added to the substantial barriers that they already faced in obtaining access to justice.

The public was entirely left to fend for itself in finding quality, reasonably priced legal representation, as there was no Lawyer Referral Information Service to provide affordable consultations to prospective clients. Some didn't even try to consult with an attorney in matters where legal representation was clearly warranted, sometimes with disastrous consequences.

Without our Lawyer Assistance Program (LAP), there was no help available to attorneys to deal with the tremendous stresses of our profession, which became worse and worse as the economy unraveled, leading to depression, unpaid bills and an increased use of alcohol and drugs. Those affected included attorneys whom LAP would otherwise have served who were not NCBA members and who had not lived or worked in Nassau County. The impact of LAP's absence was felt not only by them, but also by their families and clients.

Millions of dollars were never raised for the WE CARE Fund and distributed to our community. As a result, a long list of charitable organizations faced reductions in services to those in need, or worse still, the prospect of closing their doors altogether. There were no happy smiles of gratitude and appreciation on the faces of those who would have been invited to our Thanksgiving Day Luncheon for Seniors, Gingerbread University, Children's Holiday Festival and trips to the ballpark with underprivileged children if WE CARE had existed.

Finally, it shouldn't come as a surprise that the public image of attorneys in our community took a beating, and false and unsavory stereotypes flourished in their place. After all, there was no Bar Association to inform the media of the many selfless acts of charity and pro bono activities of those who would have been our members.

You see, George Bailey, you really had a wonderful Bar Association. Don't you see what a mistake it would be to just throw it away?

Please join us for our Wassail celebration on Thursday, December 12 at 6 p.m. It's an opportunity to celebrate all that is good in our Bar Association and to look forward to the year to come. Reservations are $20 per person. Children under age 12 are welcome at no charge. Eat, drink, share in the fellowship, be regaled by musical entertainment, and hear President-Elect John McEntee present the true tale of Wassail.

Really.

NYS Bar Association Fall Meeting Features Debate on Pro Bono

By Scott M. Karson

The annual fall meeting of the 77,000 member New York State Bar Association was held on October 31 – November 2, 2013 at the Bar Center in Albany, New York. The Association's policy-making body, the House of Delegates, met on Saturday, November 2, 2013, with NYSBA President Elect Glenn Lau-Kee of New York City presiding as Chair of the House.

The meeting of the House featured a lively debate which focused on recent amendments made by the Appellate Divisions to Rule 6.1 of the New York Rules of Professional Conduct, effective on May 1, 2013. Those amendments increased the aspirational number of pro bono hours to be provided annually by all lawyers from 20 to 50, and provided that lawyers should aspire to make annual financial contributions to organizations that provide legal services to poor persons in an amount at least equivalent to, inter alia, the amount typically billed by the lawyer (or the firm with which the lawyer is associated) for one hour of time.

Although the 50-hour goal and the billable hour financial contribution goal are aspirational, a concurrent amendment to section 118.1(e)(14) of the Rules of the Chief Administrator was enacted, requiring lawyers to report on their biennial registration forms: (a) the number of hours that the lawyer voluntarily spent providing unpaid legal services to poor and underserved clients during the previous biennial registration period; and (b) the amount of voluntary financial contributions the lawyer made to organizations primarily or substantially engaged in providing legal services to the poor and underserved during the previous biennial registration period.

The debate was triggered by a seemingly innocuous proposal by the NYSBA Committee on Standards of Attorney Conduct to amend the commentary to Rule 6.1 to reflect the change in the aspirational goal from 20 to 50 hours

See NYS BAR, Page 6

The Nassau Lawyer welcomes articles that are written by the members of the Nassau County Bar Association, which would be of interest to New York State lawyers. Views expressed in published articles or letters are those of the authors alone and are not to be attributed to the Nassau Lawyer, its editors, or NCBA, unless expressly so stated. Article/letter authors are responsible for the correctness of all information, citations and quotations.

Nassau Lawyer

The Official Publication of the Nassau County Bar Association
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January – Labor & Employment Law
February – Criminal Law
March – Personal Injury/Workers' Compensation

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Published by Long Island Business News
(631) 737-1700; Fax: (631) 737-1890
Group Publisher
Chris Eddings
Graphic Artist
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Nassau Lawyer (USPS No. 007-505) is published monthly, except combined issue of July and August, by Long Island Commercial Review, 2150 Smithtown Ave., Suite 7, Ronkonkoma, NY 11779-7348, under the auspices of the Nassau County Bar Association. Periodicals postage paid at Mineola, NY 11501 and at additional entries. Contents copyright ©2013. Postmaster: Send address changes to the Nassau County Bar Association, 15th and

"S" Corporations and the Built-In Gains Tax

Taxation is an area that most practitioners find intimidating because of the intricacies of the Internal Revenue Code, Treasury Regulations, and the technical jargon used to describe transactions and situations. While taxation is undoubtedly complex, it is important for an attorney to understand the fundamental concepts that can affect a corporate client.

Jon H. Ruiss Jr.

Over the years, the Subchapter "S" Corporation ("S Corporation") has played an important role in choice of formation for a business. However, if the S Corporation has had any history as a "C" corporation ("C Corporation"), a concept known as the built-in gains tax may surface. This article will briefly explain the important aspects of S Corporations and offer an overview of the associated built-in gains tax.

Overview of "S" Status

To understand the implications of the built-in gains tax, it is important to have some familiarity with "S" status. An S Corporation is essentially a C Corporation that elects "S" status.[1] Electing "S" status combines the formal structure of a corporation under state law with a tax regime similar to that of a partnership or limited liability company. Thus, income, deductions and tax credits "pass through" to the shareholders of the S Corporation as opposed to being taxed at the entity level, creating only one level of tax for the shareholders.[2]

To be eligible for "S" status, the entity must meet some basic requirements. The electing entity must be a domestic corporation with only one class of stock.[3] Additionally, the entity cannot have more than 100 shareholders.[4] These shareholders must also be natural persons[5] and US citizens or residents.[6] Lastly, the IRC excludes insurance companies, financial institutions, and domestic international sales corporations from electing "S" status.[7]

Major Differences Between S Corporations and C Corporations

S Corporations differ from C Corporations, particularly with respect to the entity-level tax. The C Corporation will pay tax on income it generates, then, when the business distributes cash or property to its shareholders, the shareholders will also pay tax on the receipt of that cash or prop-

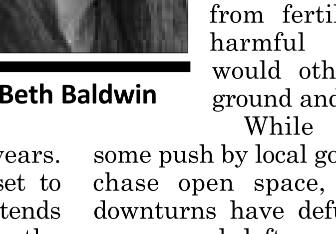
See GAINS TAX, Page 15

Preservation Pays Off

The Conservation Easement Tax Incentive

Both the federal and state governments have equipped landowners with the tools to preserve their property and receive significant tax benefits. The Conservation Easement Tax Incentive is a promoter for landowners who want to preserve their property, but who also want to offset income with significant tax deduction.

Under the Internal Revenue Code, a conservation easement donor can deduct the value of a qualified conservation easement, up to 30% of the donor's adjusted gross income per year, with a five (5) year carry-forward of any unused amount.[1] The Conservation Easement Tax Incentive sweetens the deal by allowing donors to deduct up to 50% of their adjusted gross income and extending the carry-forward period from five (5) years to fifteen (15) years. Unfortunately, this incentive is set to expire in 2013 unless Congress extends the time period or passes the "Conservation Easement Incentive Act of 2013,"[2] which makes the incentive permanent.



Beth Baldwin

A conservation easement is a voluntary and unique agreement between a landowner and a qualified conservation organization. The agreement restricts particular development and uses on a landowner's property in order to permanently preserve significant environmental resources.

On Long Island, and especially in Nassau County, where overdevelopment is causing detrimental effects to our surface waters and groundwater, the preservation of open space is the most effective tool for offsetting increased development. When property is left in its natural state, it provides a buffer to prevent stormwater run-off from entering our waterways. Natural buffers soak up run-off and filter out impurities from fertilizers, and other harmful pollutants that would otherwise enter our ground and surface waters.

While there has been some push by local governments to purchase open space, recent economic downturns have defunding these programs and left our remaining open spaces vulnerable to unsustainable development. The Conservation Easement Tax Incentive allows private landowners who love their property but are concerned about overdevelopment

See INCENTIVE, Page 19

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DETAILS TO FOLLOW

NYS BAR ...

Continued From Page 4

(although the rules themselves are the exclusive province of the Appellate Divisions, the commentary is provided by NYSBA). However, former NYSBA President Robert Ostertag of Poughkeepsie rose in opposition, emphatically noting that the rules changes were contrary to established NYSBA policy opposing mandatory pro bono reporting, and had been imposed without consultation with NYSBA. Former President Ostertag opined that the public dissemination of highly-personal information about contributions of time and money by attorneys is patently intrusive, particular to solo and small firm practitioners in smaller cities and towns and rural areas of the state.

Although most of the speakers were critical of the new rules and urged NYSBA to take action against them, at least one, Susan Lindenauer of the New York County Lawyer's Association and former general counsel to the Legal Aid Society of New York City, argued that pro bono is not charity but a professional obligation, and that 50 hours is not too much to ask.

Ultimately, the motion to approve the revised commentary to Rule 6.1 was tabled, making it likely that the matter will be revisited at the next meeting of the House of Delegates in January 2014 during the NYSBA Annual Meeting in New York City.

The House also approved the Report of the NYSBA Special Committee on Human Trafficking. This authoritative and exhaustive report focuses on three types of trafficking: labor trafficking, sex trafficking and child trafficking.

Regarding labor trafficking, the report calls for the creation of a civil private right of action; enactment of an enterprise disclosure law requiring businesses with annual revenues exceeding $100,000,000 to file an oath of non-involvement with trafficking with the New York State Department of Labor; and providing monetary rewards and whistleblower immunity to employees of entities engaged in trafficking activities and citizens who report suspected trafficking which results in the prosecution of those responsible.

With respect to sex trafficking, the report recommends that section 70.02(1)(a) of the Penal Law be amended to classify sex trafficking as a class B violent felony; that prostitution in the third degree be included as a "designated offense" for purposes of expanding eavesdropping and video surveillance authority pursuant to CPL 700.05(8)(h); creating an affirmative defense for trafficking victims charged with offenses; amending the Vacating Convictions Law by expanding it to include non-prostitution offenses, eliminating the due diligence requirements and developing uniform court rules to protect the identities of trafficking victims; and expanding the victim referral process to the New York State Office of Temporary and Disability Assistance for services to include providers of social or legal services who are well positioned to identify victims of sex trafficking.

As to child trafficking, the report calls for the elimination of coercion as an element of sex trafficking when a person who is 19 years of age or older intentionally advances or profits from the prostitution of a person under the age of 18; the elimination of criminal prosecution of minor victims of sex trafficking by raising the age of criminal responsibility for such crimes to 18; making Family Court orders of protection available to victims of sex trafficking and sexual exploitation; amending the child protective provisions of the Family Court Act and Social Services Law to explicitly include child victims of human trafficking; improving training for Family Court professionals; and amending mandated reporter requirements under the Social Services Law to include human trafficking.

The House overwhelmingly approved the report and recommendations, with the exception of that portion of the report dealing with orders of protection in Family Court, which was withdrawn by the Special Committee for further consideration.

Finally, the NYSBA Nominating Committee report to the House was delivered by Former NYSBA President and current Nominating Committee Chair Stephen P. Younger of New York City. Mr. Younger announced that David P. Miranda of Albany had been nominated as President Elect; Ellen G. Makofsky of Garden City had been nominated as Secretary; and Sharon Stern Gerstman of Buffalo had been nominated for Treasurer. Nominees for the office of Vice President for each judicial district, for members at large of the Executive Committee, and for delegates to the American Bar Association were also announced by Mr. Younger. These nominees will stand for election at the January 31, 2014 meeting of the House in New York City and, if elected, will assume office on June 1, 2014.

Scott M. Karson is the Vice President of the NYSBA for the Tenth Judicial District and serves on the NYSBA Executive Committee and in the NYSBA House of Delegates. He is a sustaining member and former President of the SCBA, a member of the ABA House of Delegates, a member of the ABA Judicial Division Council of Appellate Lawyers, a Life Fellow of the New York Bar Foundation, a Fellow of the American Bar Foundation and Vice Chair of the Board of Directors of Nassau Suffolk Law Services Committee. He is a partner at Lamb & Barnosky, LLP in Melville.

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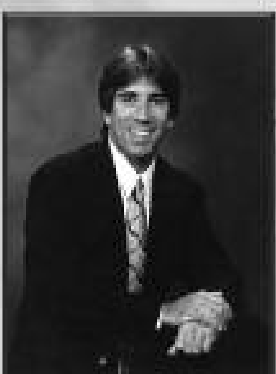

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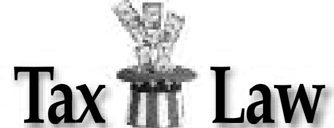


Impact of *Windsor* on Federal Tax Law

On June 26, 2013, in *U.S. v. Windsor*[1] the United States Supreme Court held that Section 3 of the Defense of Marriage Act (DOMA),[2] which excluded same-sex couples from the federal definition of "spouse," was unconstitutional. This decision impacts virtually all areas of law; Justice Kennedy, in his majority opinion, noted that there are over one thousand federal statutes and regulations which address marital or spousal status, including bankruptcy, criminal law, Social Security and veteran's benefits.

Certainly, one of the areas which will be greatly affected is federal tax law; indeed, the controversy in *Windsor* itself centered on a tax issue, the right of a surviving spouse to claim the unlimited federal marital deduction for estate tax purposes. In the wake of this case, it has been left to the various federal agencies charged with administering the federal laws to implement the Court's decision.

In late August of 2013, the IRS issued a Revenue Ruling[3] providing guidance on applying the *Windsor* decision to federal tax law. The IRS ruling answered the most pressing questions raised, and in general is quite taxpayer friendly. As a result, qualified taxpayers will be able to file refund claims for years where the statute of limitations is still open. It remains to be seen how this federal interpretation will dovetail with state taxation in states where same-sex marriages are not recognized, including those states that allow civil union or similar arrangements.

Marc Ausfresser

Bumps on the Path Ahead

There were two major issues raised by the Court's opinion. First was the federal treatment of same-sex couples who were legally married in one state, but then moved to another state where same-sex marriages are not recognized.

While *Windsor* overturned Section 3 of DOMA, which defined "marriage" for federal purposes to mean only a union between one man and woman, this holding only applies to states that have enacted legislation legalizing same-sex marriages. Section 2 of DOMA, which permits states to refuse to recognize same-sex marriages performed in other states was not challenged and remains effective. As a result, a valid same-sex marriage performed and recognized in one state, such as New York, need not be accorded any legal status by another state.

The Revenue Ruling noted above holds that, for federal tax purposes, a same-sex marriage which is validly entered into in a state that authorizes such marriage (the so-called "state of celebration") will continue to be respected regardless of the married couple's place of domicile. The IRS relies on a 1958 Revenue Ruling[4] which had held that if taxpayers entered into a common-law marriage in a state which recognizes such marriages, they would retain their status as husband and wife for federal tax purposes even if they subsequently moved to another state that did not recognize such marriages.

Michael A. Garcia

The reasoning for both the 1958 ruling and the current ruling is the need for uniformity in administration of the federal tax law. This uniformity would leave no doubt as to the status of the marriage for federal tax purposes, regardless of where the couple is currently domiciled, and such status will be consistent from year to year.

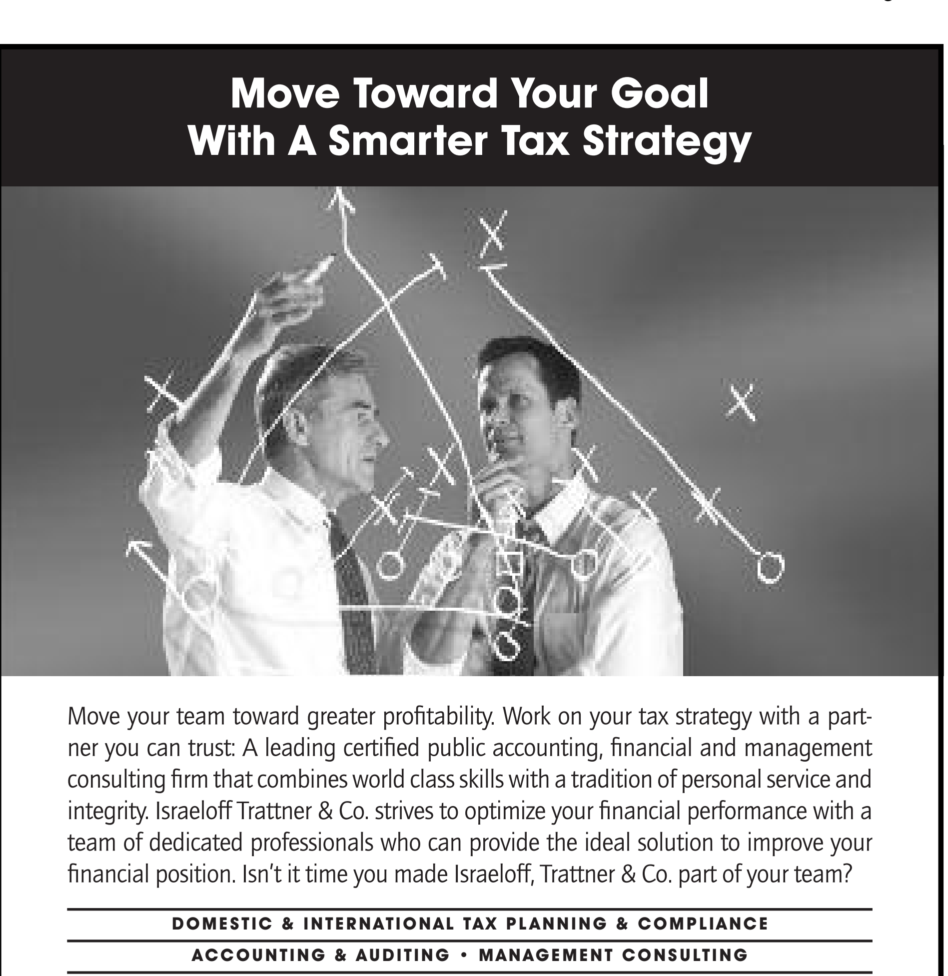
Before *Windsor*, same-sex married couples in states that recognized the marriage, such as New York, were treated as single for their federal returns, even though they were required to use a married status for their state tax filings. From now on, their married status will apply for both federal and state purposes.

This inconsistency still applies in states that allow civil unions, registered domestic partnerships and other similar arrangements which, while similar, are not officially sanctioned marriages. The revenue ruling makes it clear that only relationships denominated under state law as "marriages" will be recognized for federal tax purposes. This means that couples whose status under state law does not rise to the level of "married" will still be considered single for federal tax purposes.

However, a new inconsistency arises; same-sex couples who were legally married in one state, but now reside in a state that does not recognize such marriage, are now required to file under married status for federal purposes, but will still be deemed single for state tax returns. This issue is further complicated by the fact that many states piggy-back off the federal return, using federal taxable income as the starting point. Each state will have to provide guidance to affected taxpayers.

The second major issue raised was whether the *Windsor* decision would be

See WINDSOR, Page 20



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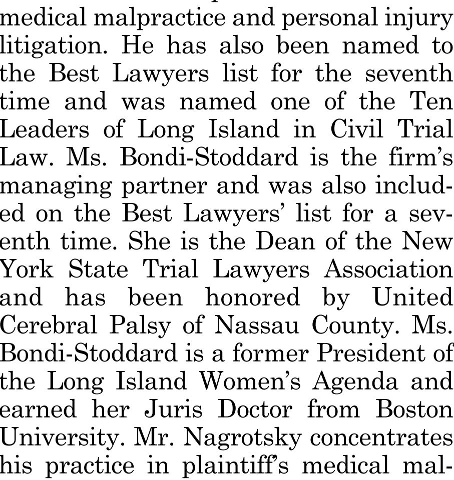
In Brief

Member Activities

Farrell Fritz P.C. partner **James M. Wicks** was named to the Top 100 New York – Metro Super Lawyers list. Mr. Wicks has been selected for inclusion on the Super Lawyers list each year since 2008.

Steven Pegalis, **Stephen Erickson**, **Annamarie Bondi-Stoddard** and **Sanford Nagrotsky**, partners at Pegalis & Erickson, were named to the 2014 Edition of The Best Lawyers in America. Mr. Pegalis, who was named to the list for the seventh time, is also the author of American Law of Medical Malpractice (Volumes 1-3) and was recently appointed as Dean Emeritus by New York Law School where he earned his Juris Doctor. Mr. Erickson, who also earned his Juris Doctor from New York Law School, is the founding member of the firm and concentrates his practice in medical malpractice and personal injury litigation. He has also been named to the Best Lawyers list for the seventh time and was named one of the Ten Leaders of Long Island in Civil Trial Law. Ms. Bondi-Stoddard is the firm's managing partner and was also included on the Best Lawyers' list for a seventh time. She is the Dean of the New York State Trial Lawyers Association and has been honored by United Cerebral Palsy of Nassau County. Ms. Bondi-Stoddard is a former President of the Long Island Women's Agenda and earned her Juris Doctor from Boston University. Mr. Nagrotsky concentrates his practice in plaintiff's medical malpractice and earned his Juris Doctor from State University of New York at Buffalo. The firm was also recognized by U.S. News as a Tier 1 "Best Law Firm."



Hon. Stephen L. Ukeiley

Salenger, Sack, Kimmel & Bavaro, LLP received a Tier 1 Ranking in the 2014 Edition of U.S. News – Best Lawyers' Best Law Firms. **Marvin Salenger** of the firm has also been included in New York Magazine's "Best Lawyers" issue. Mr. Salenger and **Jeff Kimmel** are included in the Ten Leaders in Law series, and are A-V rated by Martindale-Hubbell's Peer Review.

Emily F. Franchina, a partner at Franchina & Giordano, P.C., was recently honored by the Long Island Arthritis Foundation at their "Women on the Move" Gala for her service to the community. Ms. Franchina, a former President of the Bar Association and current Vice Chair of Fellow of the New York Bar Foundation, was previously named a Super Lawyer for Elder Law and was a recipient of the Juliette Law Award of Distinction from the Nassau County Girl Scouts.

Mark E. Alter, senior partner in the Law Offices of Mark E. Alter, was named to the 2013 Super Lawyers List in the category of Personal Injury Litigation (Plaintiffs). He is also a certified member of the Top Trial Lawyers in America® and earned his Juris Doctor from the Touro College Jacob D. Fuchsberg Law Center. Mr. Alter is a former Police Officer.

Richard K. Zuckerman of Lamb & Barnosky, LLP recently presented on the Affordable Care Act to the Council of Licensed Physiotherapists of New York, Inc.

Jennifer Cona, managing partner, and Melissa Negrin-Wiener, partner, of Genser Dubow Genser & Cona recently spoke at the 18th Annual Work/Life Conference hosted by the National Association of Mother's Centers.

Ethan A. Kobre, a commercial litigation associate of Farrell Fritz, P.C. was appointed to the junior board of directors of the Alan T. Brown Foundation to Cure Paralysis. Mr. Kobre has been involved in the organization for several years, previously serving as chair of the event committee for the Foundation's annual Family Fun Day. The Alan T. Brown Foundation offers education and prevention regarding spinal cord injuries.

Farrell Fritz P.C. received a Tier 1 Ranking by Best Lawyers and will be included in the 2014 U.S. News – Best Lawyers "Best Law Firms."

Bond, Schoeneck & King, PLLC was recognized in the 2014 U.S. News – Best Lawyers "Best Law Firms" in the practice areas of Litigation (Labor & Employment), Employment Law (Management) and Labor Law Management. The firm also was recognized with First-Tier Rankings in Education Law, Employment Law (Management), Labor Law (Management) and Litigation (Environmental, Labor & Employment and Municipal).

The Honorable Stephen L. Ukeiley, Suffolk County District Court Judge and editor of this column, was appointed Acting County Court Judge, effective January 1, 2014, and will be presiding over Suffolk County's Human Trafficking Court.

New Partners, Of Counsel and Associates

Partners **Joseph Asselta**, **David A. Loglisci** and **Jason L. Rothman** and associate **John M. Comiskey** have joined the Construction Law Department of Forchelli, Curto, Deegan, Schwartz, Mineo & Terrana, LLP. Mr. Asselta co-Chairs the Department.

Elke Stoiber has been named Of Counsel in the Real Estate and Commercial Lending Practice Groups at Certilman Balin. Ms. Stoiber, who concentrates her practice in commercial and residential real estate, was named Attorney of the Year by the Long Island Development Corporation in 2008. She is also a member of the Steuben Society of America and provides pro bono services for several organizations and serves as a mentor in the Nassau County Academy of Law and the Lawyers Involved with Kids' Education programs. Ms. Stoiber earned her Juris Doctor from Touro Law Center where she was awarded the school's award of excellence in Real Estate Transactions.

Sandra N. Busell has joined Davidoff Hutcher & Citron LLP as a partner in its Trusts & Estates Group. **Maria F. Galante** and **Dustin J. Cohen** have also joined the firm as associates. Ms. Busell is also a Certified Public Accountant and serves on the board of the Long Island Chapter of the American Heart Association. She is a frequent lecturer and earned her Juris Doctor from St. John's University of Law.

Brian A. Sands has joined the Law Office of Daniel M. Morrin in Mineola as an associate concentrating in the areas of Workers' Compensation and Social Security Disability. Mr. Sands earned his Juris Doctor from Touro College Jacob D. Fuchsberg Law Center.

New Firms and Locations

The Law & Mediation Offices of Harriette M. Steinberg has relocated to 675 Old Country Road, Westbury.

The Law Office of Louis Sternberg has relocated to 775 Park Avenue, Suite 200-12, Huntington. Mr. Sternberg concentrates his practice on matrimonial and family law matters.

The In Brief section is compiled by the Hon. Stephen L. Ukeiley, Suffolk County District Court Judge. Judge Ukeiley is an adjunct professor at both the Touro College Jacob D. Fuchsberg Law Center and the New York Institute of Technology, and author of *The Bench Guide to Landlord & Tenant Disputes in New York*®.

MEMBER BENEFIT

Join the Lawyer Referral Information Service Panel

The Nassau County Bar Association Lawyer Referral Information Service (LRIS) is an effective means of introducing people with legal problems to attorneys experienced in the area of law in which they need assistance. In addition, potential new clients are introduced to members of the Service Panel. Membership on the Panel is open exclusively as a benefit to active members of the Nassau County Bar Association. Professional insurance coverage is required.

To join, please go to the Nassau Bar website, www.nassaubar.org, and download the application form, choose the panels on which you would like to serve, sign the agreement form, provide a copy of your current professional insurance coverage, and fax or mail with your check or credit card information to:

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Questions? Contact Pat Carbonaro, LRIS Coordinator
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Committee Reports

Appellate Practice

Meeting Date: 11/19/13
Chair: Jackie Gross

Committee member Thomas Villecco, Esq., gave a presentation entitled "Leaveworthy: The Art of Certiorari Practice before the New York Court of Appeals," and provided excellent "how-to" tips on obtaining leave to appeal and defending against leave applications.

Upcoming lunch meeting scheduled for Tuesday, January 14, 2014, at 12:30 p.m., with the anticipated lecture entitled "Electronic Resources for Appellate Lawyers," with a representative from Westlaw scheduled to participate. All NCBA members are welcome to attend.

Matrimonial Law

Meeting Date: 11/13/13
Chair: John DiMascio, Jr.

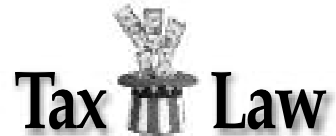
Support Magistrates Diane M. Dwyer and Elizabeth A. Bloom from the Nassau County Family Court presented the CLE program entitled: "Family Court: Where Divorce Agreements May Encounter a Second Life." Magistrates Dwyer and Bloom discussed problems that often arise when separation agreements and stipulations of settlement are challenged, modified or enforced in Family Court, and gave advice on how these agreements can be better drafted to avoid these problems in the future.

The committee's new monthly meeting feature, "A New Case from a New Face," was presented by Jacqueline Caputo, Esq., who discussed a recent Third Department relocation case, Matter of *Michelle V. v. Brandon V.*

Upcoming committee meeting is scheduled for December 11, 2013, which is the annual Holiday Party with live music, buffet dinner and cocktails.

Michael J. Langer

Michael J. Langer, an associate in the Law Offices of Kenneth J. Weinstein, is a former law clerk in the United States Court of Appeals for the Second Circuit, and a former Deputy County Attorney in the Office of the Nassau County Attorney. Mr. Langer's practice focuses on matrimonial and family law, criminal defense and general civil litigation.



The Tax Consequences of Income-Based Repayment of Student Loans

This Fall, the Department of Education is launching a new initiative to contact student loan debtors and inform them of various repayment and forgiveness options.[1] One such option is the income-based repayment plan ("IBR"), enacted by Congress in 2007 as a response to unprecedented rates of defaulting student loans.[2]

Matthew Evan Rappaport

Importantly, the federal government and the mainstream media scarcely mention the personal income tax consequences of IBR,[3] yet these tax consequences may significantly affect a debtor's decision to use IBR as his or her method of repayment.

IBR is a flexible, affordable payment plan intended to assist student loan debtors in meeting monthly payments. As of July 1, 2009, IBR allows debtors to make monthly payments based on the graduate's gross income, without regard to the total outstanding balance of the debtor's loans.[4] Thus, debtors can avoid default using IBR, even during periods of unemployment or substantial underemployment.

Under IBR, debtors are permitted to make monthly payments equivalent to 15% of the difference between the debtor's adjusted gross income and 150% of the poverty line for the taxpayer's family size.[5] After 25 years of timely payments, any outstanding balance, including interest, is cancelled.[6] There is no requirement that the debtor work in any particular field.[7]

Put simply, IBR allows debtors to pay no more than 15% of "discretionary" income toward student loans; after 300 monthly payments, the remaining balance will be forgiven, regardless of whether the debtor works in the public or private sector.

For most debtors, however, the forgiveness of their student loan balances under IBR will come with a significant tax consequence: any amount forgiven under IBR will be taxed to the debtor as ordinary income. The Internal Revenue Code broadly defines gross income as "all income, from whatever source derived."[8] This definition is followed by a list of specifically enumerated items, including "income from [the] discharge of indebtedness."[9]

In *United States v. Kirby Lumber Co.* the Supreme Court confirmed that cancelled indebtedness must be reported as part of a taxpayer's gross income because "by becoming less indebted, the taxpayer has simultaneously become wealthier, and therefore, should be taxed on his or her accession to wealth."[10] *Kirby Lumber* still stands to this day as the landmark case regarding cancellation of indebtedness income.

Marion D. Livermore

Section 108 of the IRC has specifically provided several exceptions that result in exclusion of cancelled indebtedness from gross income.[11] For example, gross income does not include discharge of indebtedness when the discharge occurs in a title 11 bankruptcy proceeding.[12] Section 108(f) specifically excludes the income from the discharge of federal student loan indebtedness from gross income, but only when the debtor works for a certain period of time in public service or for the public benefit, which usually entails working for the federal government, a state government, or a 501(c)(3) not-for-profit organization.[13]

Notably absent from the list of exceptions is income from student loan debt forgiven under any other circumstances, including forgiveness pursuant to IBR.[14] Thus, cancellation of indebtedness income from the forgiveness of student loans under IBR will be taxed to the debtor as ordinary income, resulting in a sudden and potentially significant personal income tax liability to the extent of the debtor's marginal income tax rate.

Furthermore, the debtor will not receive a corresponding amount of cash with which to satisfy the resulting tax liability. This cash shortfall is a concept known as "phantom income," a phenomenon more commonly encountered in corporate and partnership tax law.[15] For debtors with total outstanding balances close to the reported national average of approximately $30,000,[16] the amount of "phantom income" recognized after 25 years should not prove unmanageable, provided the debtors immediately secure adequate employment after graduation and remain employed for the duration

See STUDENT LOANS, Page 20

The GST Allocation Puzzle

In the preceding years, many individuals sought to take advantage of the estate tax exemption, which steadily climbed from 1 million to 3.5 million to 5 million before the estate tax Armageddon of 2013.

But, consistent with any countdown to Armageddon, tax life remained static. And so, many individuals made large gifts, completed massive estate plans, filed their gift tax returns, and then went on with their life. However, it is the gifting season again and time once more to think about that enigma: Generation Skipping Transfer Tax.

Moira A. Jabir

Which Transfers Get Taxed?

Generation Skipping Transfer Tax (GSTT) is a minor part of the federal transfer tax system and usually rears its head when the taxpayer and his or her advisor fails to anticipate its application or allocates the Generation Skipping Transfer (GST) exemption incorrectly on the gift tax return (Form 709).

GSTT is a tax imposed on both outright gifts and transfers in trust to/or for the benefit of individuals two or more generations younger than the donor. It is triggered in the most basic sense when a grandparent makes a gift to his or her grandchild, although it becomes more difficult to decipher the trigger when a trust is involved.

In order to understand GST exemption allocation, we need to answer a few questions: (1) who is the transferor? (2) is the transfer for a skip or non-skip person? and, (3) what triggered the Generation Skipping Transfer Tax?

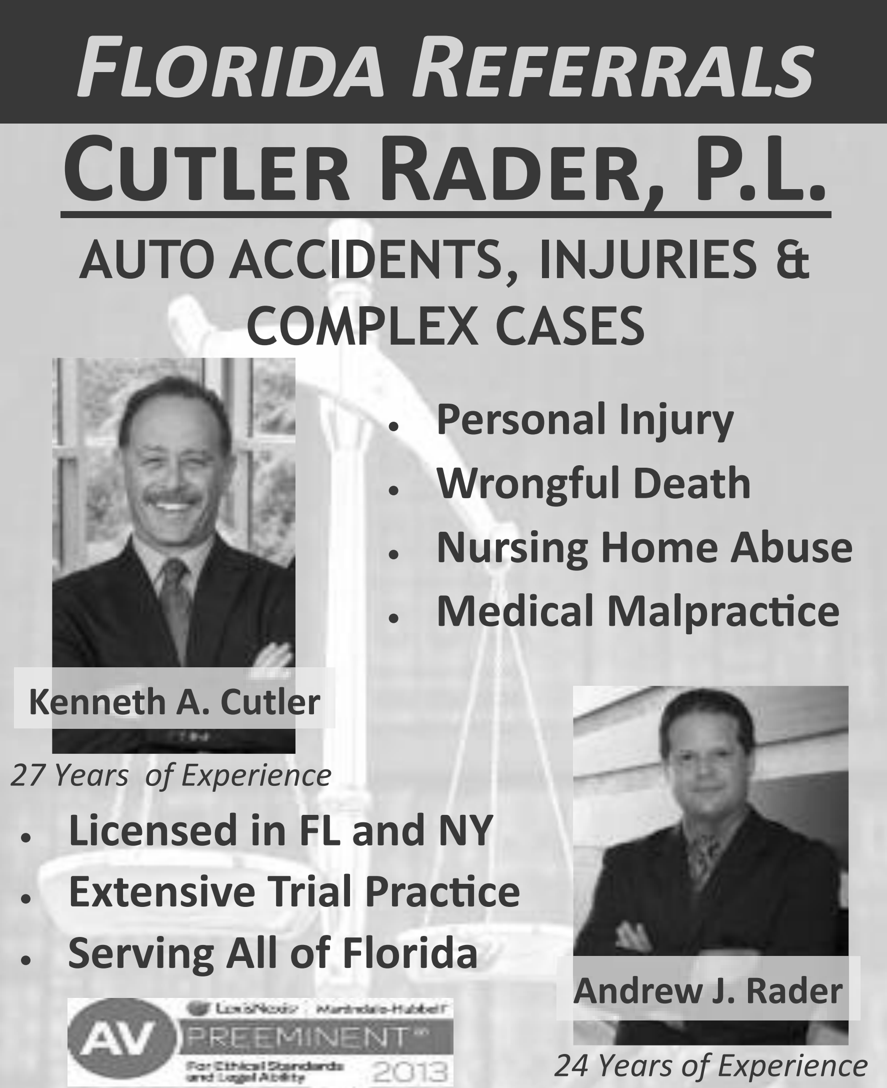
A transferor, quite simply, is a person who gifts property (directly or by means of a trust).[1] A transferor can be a grandfather who gives a grandchild a birthday present, a spouse who exercises her power of appointment over property that qualified for the marital deduction, a beneficiary of a trust who exercises, releases or allows to lapse a general power of appointment over property held in trust, or parents who set up a dynasty trust. When spouses consent to a gift split, each spouse is the transferor for GSTT purposes as to one-half of the gift, even if the non-donor spouse split less than one-half of the gift.[2]

A skip person is a natural person who is at least two generations below the transferor (grandchild, grandnephew, grandniece, etc.), as long as the deceased parent rule (IRC §2651(e)) does not apply, or in the case of individuals unrelated to the transferor, at least 37.5 years younger.[3] A trust can be a skip person if it has all of the trust interests presently held by a skip person.[4]

Trusts that are not skip persons may still be subject to GSTT when future distributions and terminations occur and may be considered an indirect skip, which is any transfer of property (other than a direct skip) subject to gift tax made to a GST trust.[5]

A taxable distribution is any distribution from a trust for a skip person (other than a taxable termination or a

See GST, Page 21



Pro Bono Attorney of the Month

William J.A. Sparks

By Gale D. Berg, Esq.

This month we are delighted to honor William J.A. Sparks as the Pro Bono Attorney of the Month for his commitment to the Nassau County Bar Association Mortgage Foreclosure and Sandy Clinics and the pro bono Foreclosure Settlement Conference initiative. His commitment is consistently exemplified by his volunteering and his ability to step up whenever we need him over the last three years.

For those of you unfamiliar with the Mortgage Foreclosure Project and monthly foreclosure clinics, volunteer attorneys provide one-on-one consultations at our monthly clinics to Nassau County homeowners concerned about or facing foreclosure issues. Attorneys may also volunteer as “Attorney of the Day” to represent homeowners and/or provide information and assistance at court-mandated conferences in Supreme Court.

Mr. Sparks graduated from Duke University School of Law, and is admitted to practice in New York, New Jersey and Florida. His career has included both large firms such as Dewey Ballantine Bushby Palmer & Wood as well as Fortune 500 Corporations such as Olin and W. R. Grace & Co. He has managed litigation teams responsible for handling complex litigation and other corporate legal problems. His expertise includes product liability and tort litigation management, Chapter 11 Reorganization as well as focusing on legal ethics specifically involving internal investigations and attorney client privilege. He has served as Vice Chair of the Ethics Committee for the Nassau County Bar Association.

Following his decades in law firms and as corporate counsel, he recently became certified as a Mediator and Arbitrator in order to serve on ADR panels and was also appointed a Fee Arbitrator.

Previously, Will taught as an Adjunct Professor of Law at Pace Law School from 1984 through 1991 on Professional Responsibility and Ethics; and Products Liability.

In his spare time, Will has two show dogs and is active in the sport of conformation. He has finished two Norwich terrier champions and is currently working with Hugo (CH Paradym Victor Hugo Get It) and Freddie (GCH CH Foxwood Freddie Set Go). He is also a founding member and contributor to AKC’s charitable Humane Fund whose mission includes encouraging responsible pet ownership, education and helping victims of domestic violence.

Will volunteers because he thinks he can add value from his corporate background. He wants to put years of experience to use, particularly in the court room, which he accomplishes through representing homeowners at the mandatory conferences. He believes in the legal system and passes on that positive approach to those homeowners and lawyers with whom he comes in contact.

We are proud to acknowledge his generosity and assistance to the community by honoring William J. A. Sparks as the Pro Bono Attorney of the Month.

**Attorneys interested in working on any of these pro bono efforts either at a Mortgage Foreclosure/Sandy Clinic, or at Nassau Supreme Court Mandatory Conferences, can call Gale D. Berg, Director of Pro Bono Attorney Activities at NCBA or email her at gberg@nassaubar.org.*

NCBA New Members

We welcome the following new members

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Kevin M. Butler
Jennifer Ecker
Christine Fung
Evan M. Goldberg
Christina Jonathan
Jeffrey A. Lhuillier
Margaret M. O'Keefe
Abbe C Shapiro
Jennifer Morgan Simcovitch
Craig Michael Spierer
Jason Adam Stern

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Erika G. Castro
Jason Denis
Michael R. Gionesi
Anastasiya Lipatov
Leah Peyman
Holly P. Pratesi
Robert M. Reichenbach
Andrew Sack
Cody B Sibell

In Memoriam

Kenneth A. Bernstein
Morris R. Sherman

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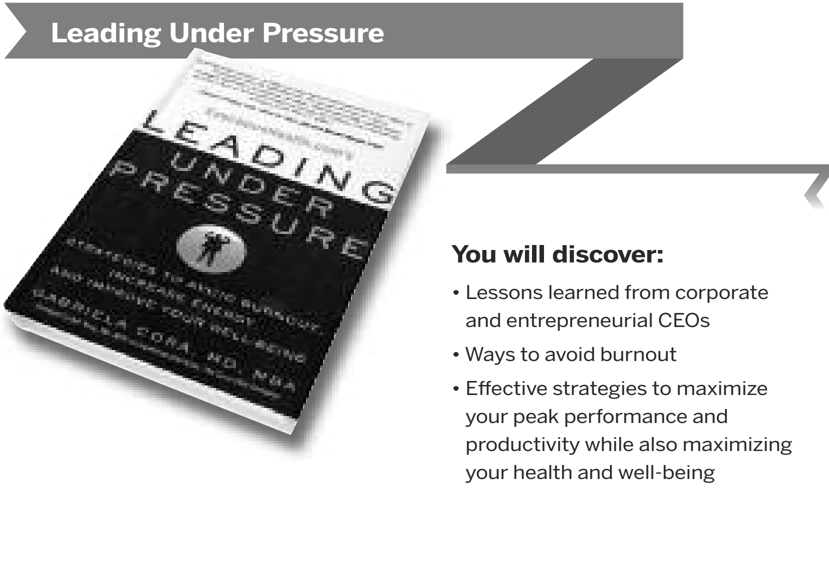

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Qualified Use in 1031 Exchanges

Taxes and Bears and Brothers, Oh My!

With all of the tax law changes that were implemented at the beginning of this year, and all of the talk in Congress about a major overall in the Internal Revenue Code in general, many of our clients have asked if there have been any significant changes in the regulations that apply to tax deferred exchanges under IRC §1031.

Michael S. Brady

Perhaps due to recent shutdown of the federal government and the constant debate over the debt ceiling, both Congress and the Treasury Department have left 1031 exchanges alone, at least for now. However, in the last few years, the United States Tax Courts have decided several cases that shed light on the issue of "qualified use."

In order for a property to be included in a tax deferred exchange, it must be held for "productive use in a trade or business or for investment."[1] Both the relinquished property and the replacement property must be held for this purpose. Property held purely for personal use will not qualify for tax deferral under IRC §1031.[2] Recent cases suggest that this determination involves intensive facts and circumstances analysis, and that bears and violent brothers may pay pertinent roles:

Goolsby v. Commissioner, TC Memo 2010-64 (2010). The court found that the Goolsbys did not hold the replacement property acquired in their exchange for investment, where:

- the Goolsbys moved into the property two months after they acquired it;
- the purchase of the property had been contingent on the Goolsbys' sale of their primary residence;
- the Goolsbys closed on the sale of their primary residence one month before acquiring the replacement property and moved in with their in-laws;
- prior to the acquisition, the Goolsbys asked their qualified intermediary for guidance on whether and when they could move in to the property;
- two weeks after purchasing the property, the Goolsbys obtained building permits to finish the basement;
- the only effort to rent the property was to place an ad in the newspaper; and
- the Goolsbys failed to research the potential to rent the property or even whether rental was permitted by the home owner's association;

Reesink v. Commissioner, TC Memo 2012-118 (2012). The court found that the Reesinks did hold their replacement property for investment, even though they moved into it eight months after they acquired it in a 1031

See 1031 EXCHANGES, Page 22

Protect This House

Tax Implications of Ownership Transfers

Home is where the heart is. This is especially true for many older clients. But the home is not only a sentimental centerpiece; it is also often a person's most valuable asset. For this reason, many have a strong desire to protect their home's value from the costly expense of long term care. Achieving this goal, though, often requires a transfer of ownership of the property.

Medicaid eligibility, in particular, often requires divestment of assets[1] and may impose a penalty period for transfers made within the five years prior to entering a nursing home.[2] Any transfers made prior to the five-year look-back period have no impact on Medicaid eligibility. There are several different ways to effectuate the transfer of a senior's home while maintaining Medicaid eligibility and minimizing tax consequences.

Outright Transfer of Real Property

The outright transfer of a residence with no consideration is accomplished by signing a deed transferring full ownership of the residence. This transfer method offers the transferor little in the way of protection and tax advantages. An outright transfer results in the transferor's loss of complete control over the residence including the legal right to live there. In addition, certain real estate tax benefits are lost, such as STAR exemptions and veteran or senior citizen tax exemptions.

Monica P. Ruela

A residence transferred outright with no consideration will also result in a loss of the benefit of the capital gains exclusion. The US Code permits an individual to exclude from gross income up to $250,000 ($500,000 for a married couple) of the gain from the sale of the primary residence when certain requirements are met. To qualify for the exclusion, the individual must have owned the home for at least two years and lived in the home as his or her primary residence for at least two years during the five year period prior to the sale date.[3]

There are exceptions to this rule. For instance, an individual who entered a nursing home can still benefit from the capital gains exclusion if he or she lived in the house for at least one year during the five year period prior to the sale of the house.[4]

With an outright transfer, the transferee takes the residence subject to the transferor's basis, or the value of the residence at the time the transferor purchased the residence plus capital improvements. If the residence was not the transferee's primary residence for at least two years prior to the date of sale, the transferee will not qualify for the capital gains exclusion and will incur capital gains tax on the appreciation of the residence using the transferor's basis. The capital gains tax in this situation can be quite significant in areas like Long Island, where housing values have appreciated tremendously in the last 50 years.

Bear in mind, as a completed gift, an outright transfer requires the filing of a federal gift tax return even if no gift taxes are due.[5]

Transfer Retaining a Life Estate

Retaining a life estate in a residence involves the preparation and signing of a deed from the homeowner, or life tenant, to another individual, or remainderman. The deed transfers the property to the remainderman and includes language indicating the life tenant is retaining a life estate in the property.

This transfer method offers the life tenant more protection and tax advantages than an outright transfer. A life estate provides the life tenant with the right to live in the residence for his or her lifetime and the life tenant retains his or her property tax exemptions. The life estate cannot be terminated by a future sale without the consent of the life tenant.

One drawback to a transfer retaining a life estate, from a Medicaid eligibility perspective, arises when the residence is sold during the life tenant's lifetime.

If the life tenant is receiving Medicaid benefits, or is about to apply for such benefits, the portion of the proceeds attributed to the life tenant based upon his or her current age must be paid to the life tenant. The valuation of both the life tenant's interest and the remainderman's interest in the property is determined pursuant to Section 7520 of the Internal Revenue Code, which requires the use of Table S for valuation of a life estate interest. This return of funds to the Medicaid applicant or recipient can make the individual ineligible for Medicaid benefits.

Capital gains are also a concern when using the life estate deed. If the residence is sold during the life tenant's lifetime, the life tenant can apply the capital gains exclusion only to his or her portion of the gain. The remainderman's portion from the sale, however, will likely be subject to capital gains tax.

For example, assume Mom purchased her home 40 years ago for $50,000 and made no capital improvements. In 2008, Mom transferred her residence retaining a life estate to her daughter. In October 2013, Mom is 85 years old and the residence is sold for $500,000. There is a gain of $450,000 ($500,000 - $50,000 basis).

Per IRS tables, the IRC § 7520 interest rate for October 2013 is 2.4% and the corresponding section of IRS Table S indicates that an 85 year old owns a life estate interest of 13.235%. Mom's interest in the residence is $66,175 ($500,000 x 13.235%) and Mom's basis is $6,617.50 ($50,000 x 13.235%). Mom applies her $250,000 capital gains exclusion to her gain of $59,557.50 ($66,175 - $6,617.50), eliminating capital gains tax for Mom. Daughter's interest in the property is 86.765% or $433,825 ($500,000 x 86.765%). Daughter's basis is $43,382.50 ($50,000 x 86.765%).

Daughter has a capital gain of $390,442.50. Daughter cannot benefit from the $250,000 capital gains exclusion unless the property was her primary residence for at least two years prior to the sale of the property. Depending on daughter's income tax bracket, she could pay as little as $0 in taxes on

See TRANSFERS, Page 22

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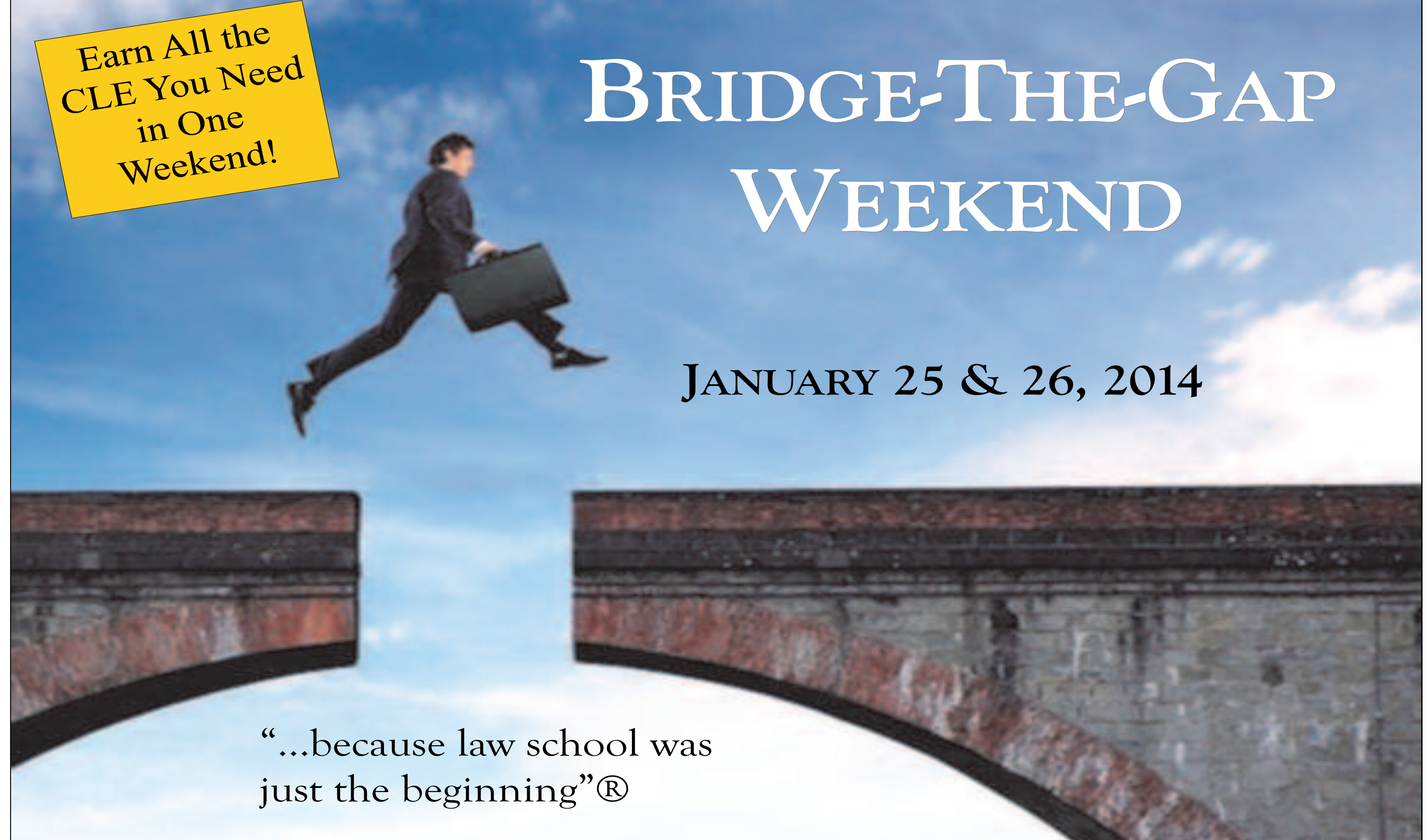

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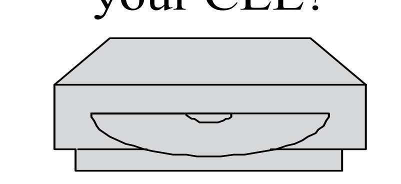

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– Evidentially Speaking –

Refreshing Recollection – Let Me Count the Ways ...

By Hon. Arthur M. Diamond

What trial lawyer worth his salt (I have no idea what that means) has not gone through the time worn exercise of refreshing his witnesses' recollection: *"Mr. Witness, please look at what's been marked as Plaintiff's Exhibit 3 ... I direct your attention to the third line ... please read that to yourself and look up when you are finished ... does that refresh your recollection as to whether or not you said anything to the police officer at the scene of the accident?"*

While that dance occurs in many courtrooms everywhere every day, trial lawyers should be aware there are several other ways and circumstances under which a witness's memory can be refreshed. It may be for either direct or cross examination – the same principles apply. Remember that the writing, in most cases, will not be independently admissible, nor does it have to be and its contents should not be disclosed to the jury. There are two exceptions to those rules – past recollection recorded and prior inconsistent statements.

Past Recollection Recorded

I particularly like the Court of Appeals case of *People v. Taylor*,[1] for its discussion of this issue. In *Taylor*, a witness testified that two weeks after an alleged rape of a neighbor in her mother's building the witness was visiting her mother. While there she observed a man come to the victim's door, knock and ask for the victim. There was no answer and he left. The witness wrote down the license plate number and called the detective assigned to the case. He was not in and so another detective took the message with the license plate. When the case detective received the message he was able to identify the car and subsequently the owner who was then charged with two rapes.

At the time of the trial, the witness had lost the piece of paper with the license plate number on it and she could not remember it. The first detective to whom she gave the message testified that while he recognized the message he gave to the carrying detective to be in his handwriting, he said that he had no recollection of writing it down. He said it was his practice to be as accurate as possible in taking messages.

The court allowed the memo as evidence of past recollection recorded. The Appellate Division affirmed and the Court of Appeals reversed the conviction. The court described the requirements for admission of such evidence: the witness observed the matter recorded; the recollection was fairly fresh when it was recorded; the witness can testify now that the record correctly represented his/her knowledge and recollection when made and the witness lacks sufficient present recollection of the recorded information. Here, the court held that the requirements were not satisfied because the recording detective had no recollection of the information given by the witness nor any memory of making the memo. There was no testimony to support the accuracy of what the observer-sender accurately saw and therefore it was error to admit testimony concerning the license plate.

Prior Inconsistent Statements … Refreshing Recollection

When using a prior written inconsistent statement of a witness, the contents may be read to the jury so long as the statements regard a material fact in the case. In a criminal case, you may not read the prior inconsistent statements of your own witness unless it is a sworn statement or signed by the witness. I often encounter demands by opposing counsel to see the document being used before it is shown to the witness. I generally would not allow inspection until the document is offered into evidence. However, according to the New York Evidence Handbook,[2] opposing counsel has a right to inspect it under these circumstances, citing *People v. Gezzo*.[3]

Practitioners should also be aware that an adversary has the right to inspect writings used by a witness before trial used by the witness in preparing to testify. These writings may also be introduced at trial for the purpose of impeaching the witness's credibility. An excellent example of this would be the medical malpractice action *Chabica v. Schneider*[4] where the Second Department held that the defendant was entitled to inspect a diary that plaintiff had kept regarding contacts with the defendant physician during the time of treatment. At trial, the plaintiff testified that he had in fact read through the diary prior to testifying. On the stand, the witness had not used the diary to refresh his recollection but the court held that opposing counsel had a right to inspect the diary for the purposed of cross examination.(Note that the principle applies to documents used to refresh for the purposes of preparing for deposition as well.)

Impact of Privilege

Be aware that issues of privilege also may arise here as well. For example, if the witness uses an otherwise privileged document to prepare for trial, what effect does that have on the privilege? Not surprisingly, it depends on the contents. Remember that CPLR 3101(d)(2) states, in sum, that "materials otherwise discoverable ... and prepared in anticipation of litigation or for trial by or for another, or by or for that other party's representative (including an attorney...) may be obtained only upon a showing that the party seeking discovery has substantial need of the material in the preparation of the case and is unable without undue hardship to obtain the substantial equivalent of the materials by other means." Generally, I believe that the privilege will be jeopardized if the witness has refreshed his recollection with a document that has been prepared for the litigation. On the other hand, where an attorney has prepared a writing for the client-undeniably work product – and the witness reviewed it before testifying, the likelihood is the privilege will remain intact.

See you next column!

Hon. Arthur M. Diamond is a Supreme Court Justice in Mineola. He welcomes evidence questions & comments and can be reached at adiamond@courts.state.ny.us.

1. 80 N.Y.2d 1(1992)
2. Martin, Capra and Ross:, New York Evidence Handbook, Section 6:13, at 604 (page) [1st ed. 1997]
3. 307 N.Y. 385 (1954)
4. 213 A.D.2d 579 (2nd Dept. 1995)

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GAINS TAX ...

Continued From Page 5

erty. Since an S Corporation is a “pass through” entity, one layer of that “double tax” is removed. Accordingly, the shareholders of the S Corporation will only have to pay tax on the “passed through” income.[8] Each shareholder will report the income based on his or her *pro rata* share of ownership.[9]

Another major difference is the treatment of distributions made to the shareholders. Cash distributions made by a C Corporation, are normally taxable.[10] In this regard, C Corporations have limited flexibility in distributing cash to shareholders, which promotes shareholders to distribute cash through other means. For example, the owners of a C Corporation may be motivated to classify cash distributions as rent, salary or interest. While this strategy may be successful, the IRS scrutinizes these “distributions” and may classify them as taxable. Conversely, an S Corporation provides a more flexible approach to distributing cash to its shareholders because cash distributions are generally not taxable.[11]

Furthermore, when a C Corporation distributes appreciated property to its shareholders, the IRC treats this distribution as if the corporation sold the property to its shareholders for the property’s then fair market value.[12] This type of transaction results in taxable income for the corporation and the shareholders. An S Corporation, however, is generally not taxed on such a transaction.[13]

The Built-In Gains Tax

Hypothetically, if a C Corporation converts its status to an S Corporation, it may avoid immediate tax consequences. In that case, all C Corporations should convert if the shareholders are willing to relinquish C Corporation status to avoid the entity-level tax. However, the built-in gains tax prohibits such gamesmanship.[14]

The built-in gains tax was enacted by the 1986 Congress as part of the overhaul to the IRC. Since S Corporations are not taxed on the distribution of appreciated assets,[15] Congress was concerned that some C Corporations would convert to S Corporations, circumventing a layer of double tax in distributing assets. Under URC § 1374, an S Corporation that was formerly a C Corporation is subject to an entity-level income tax, at the highest C Corporation tax rate,[16] on disposition of appreciated assets.[17] Notably, the tax will only result on the pre-conversion gain lurking in assets.

The threat of the built-in gains tax is not interminable because it only applies to the 10-year period starting from the date of conversion, known as the “recognition period.”[18] In recent years, Congress reduced the recognition period for the built-in gains tax.[19] This shortened recognition period is set to expire at the end of 2013 if Congress takes no action.

As an example of how the built-in gains tax applies, suppose that XYZ, Inc., holds an asset that has a value of $10,000 and a basis of $5,000 and converts from a C Corporation to an S Corporation in Year 1. In Year 3, XYZ, Inc. sells that asset for its then fair market value of $15,000. There is a total gain of $10,000 resulting from the sale of the asset; however, part of that gain, $5,000, is considered built-in gain because it is the excess of the fair market value over the basis at the time of conversion. Assuming that the highest corporate tax rate is 35%, XYZ, Inc. shareholders will pay $1,750 in built-in gains tax on the sale of the asset.

The calculation for determination of built-in gains can be quite complex. The applicable Treasury Regulations provide a rigorous formula for determining built-in gains. The goal of this calculation is to determine the net tax consequences to the corporation in a hypothetical liquidating sale of the entire business.[20]

Navigating the Built-In Gains Tax

One significant issue that arises with conversion is the appraisal of the business’ assets. A higher fair market value at the time of conversion risks greater potential for built-in gains to arise. To reduce the tax liability associated with conversion, it is imperative to obtain a proper appraisal of the assets at the beginning of the recognition period.

Proper appraisal will ensure that the IRS cannot dispute amounts relating to the appreciation of assets and increase the built-in tax gains tax. The onus is on the taxpayer to establish that a portion of the gain on the sale constitutes post-conversion appreciation.[21] To achieve a proper appraisal, the appraiser should possess the relevant qualifications for valuing assets in similar businesses and should also be familiar with the IRC and the Treasury Regulations. This will ensure that the IRS has little room to dispute pre-conversion fair market value.

Another issue that emerges in the conversion is the sale of inventories. Surprisingly, the built-in gains tax applies to the sale of inventory during the recognition period.[22] Since the built-in gains tax may apply to individual sales of products during the recognition period, day-to-day operations may trigger the built-in gains tax.

This can create a serious problem for an S Corporation not utilizing the “last in-first out,” or LIFO, inventory system. Generally, if the S Corporation does not use LIFO, the corporation will be required to treat the inventory items on hand at the beginning of the recognition period as the first items sold during the recognition period. This means that if inventories generally turn over at least once each year, the gain lurking in inventory may be subject to the built-in gains tax.[23]

Yet another important concern that arises in the conversion is the use of favorable tax attributes. Throughout its lifespan, a C Corporation may accumulate a number of tax attributes that can be carried forward or back to lower its tax liability. These tax attributes include net operating losses, excess charitable contributions or certain tax credits.

However, an S Corporation generally cannot carry forward or back favorable tax attributes.[24] This is contrary to the underlying policy of the built-in gains tax, which is to treat the S Corporation as if it remained a C Corporation. To reconcile this disparity, the IRC allows an S Corporation to use some of those favorable tax attributes obtained as a C Corporation to reduce the built-in gains tax.[25] However, it is important to note that the IRC does not permit full use of all favorable tax attributes, such as excess charitable contributions.[26] Practitioners advising a converted S Corporation should be fully aware of the favorable tax attributes that may reduce potential built-in gains tax.

Conclusion

The conversion to an S Corporation may seem simple from a mechanical standpoint, but the built-in gain lurking in the corporation’s assets may complicate matters and subject the S Corporation to an additional tax. Attorneys representing business owners wishing to convert or that have converted in the past should take care in planning dispositions of assets to minimize the potential for built-in gains tax.

Jon H. Ruiss, Jr. is an associate at Ruskin Moscou Faltischek, PC, in Uniondale, and is also a Certified Public Accountant.

1. *See* IRC 1362(a).
2. *See* IRC § 1366.
3. IRC § 1361(b).
4. IRC § 1361(b)(1)(A).
5. IRC § 1361(b)(1)(B). *See* IRC § 1361(c)(1)(A), (B) for exceptions.
6. IRC § 1361(b)(1)(C).
7. IRC § 1361(b)(2).
8. *See* IRC § 1363.
9. *See* IRC § 1366(a)(1).
10. *See* IRC § 301 et. seq.
11. Some distributions to S Corporation shareholders may be taxable. *See* generally IRC § 1368 and Treas. Reg § 1.368-3.
12. IRC § 301(b)(1).
13. *See* IRC § 1368.
14. *See* IRC § 1374.
15. *See* discussion, *supra.*
16. IRC § 11(b).
17. IRC § 1374(d)(7)(A).
18. IRC § 1374.
19. *See* American Recovery and Reinvestment Act of 2009, Pub. L. No. 111–5, 123 Stat. 115 (2009), and Small Business Jobs Act of 2010, Pub. L. No. 111–240, 124 Stat. 2504 (2010).
20. IRC § 1374(b. *See also* Treas. Reg. §§ 1.1374-1 & 1.1374-2.
21. IRC § 1374(d)(3).
22. Treas. Reg. § 1.1374-7(a).
23. *See* Treas. Reg. § 1.1374-7(b).
24. IRC § 1371(b)(1).
25. IRC § 1374(b)(2), (3).
26. *See* IRC § 170(d)(2).

Young Lawyer of the Month

Cory H. Morris

By Andrea M. Brodie

The Young Lawyers Committee (YLC) of the Nassau County Bar Association is pleased to highlight the achievements of Cory H. Morris, Esq.

As an associate with the Law Offices of Frederick K. Brewington in Hempstead, Cory H. Morris, Esq. represents clients in civil rights litigation.

In 2008, Mr. Morris graduated from Adelphi University with a Bachelor of Science in Criminal Justice. He also graduated from Adelphi University in 2010 with a Masters in General Psychology, with a concentration on forensic psychology, substance abuse and impulsive disorders.

Mr. Morris graduated cum laude from Touro College Jacob D. Fuchsberg Law Center in 2012. While at Touro, Mr. Morris was the recipient of several awards and fellowships: Brian Lord Public Interest Graduation Award, Berg Public Interest Fellowship, and Howard Glickstein Public Interest Fellowship. Mr. Morris also participated in the Civil Rights Clinic and interned with the Suffolk County Chapter of the New York Civil Liberties Union.

He worked on challenging the Suffolk County E-Verify legislation, cell phone registry legislation, and the expansion of and conditions in the Suffolk County prisons. Additionally, Mr. Morris participated in and conducted “know your rights” workshops for immigrants’ rights and students’ rights.

Mr. Morris is admitted to practice law in the State of New York and in the Eastern and Southern Districts.

Mr. Morris is an active and contributing member of the New York State, Suffolk County and Nassau County Bar Associations. Additionally, Mr. Morris was recognized by his peers for his dedication and commitment to public interest and social justice. In October 2013, Mr. Morris was recognized with the Equality Award from the Suffolk County New York Civil Liberties Union at their 50th Anniversary Gala.

The YLC congratulates Mr. Morris on his accomplishments and continued commitment to social justice and wishes him continued success in his endeavors.

Andrea M. Brodie, Esq. is an associate at Abrams, Fensterman, Fensterman, Eisman, Formato, Ferrara & Eineger, LLP in Lake Success and Chair of the Young Lawyers Committee.

TAX DATA ...

Continued From Page 3

prohibited from freely sharing taxpayer information with FBAR Auditors unless a "Related Statute Memorandum" is first obtained.[3]

This means it must first be established that the Title 31 (FinCEN) violations are "related" to Title 26 (Income Tax) violations before the income tax data can be released. This was premised on the belief that Agents should not have carte blanche to peruse any income tax return they would like merely to identify its potential for FBAR violations. In fact, the IRM sets forth the repercussions for the privacy violation itself:

Without a related statute determination, Title 26 information cannot be used in the Title 31 FBAR examination. Any such use could subject the persons making the disclosure to penalties for violating the disclosure provisions protecting Title 26 return information.[4]

These issues recently came to the forefront in *Jon C. Hom Associates, Inc. v. the United States*.[5]

In *Hom*, the taxpayer argued that the IRS should be precluded from sharing information discovered during an income tax audit with the FBAR Investigator referred to and sought damages for the unauthorized disclosure. He also proclaimed that the privacy protections under statute[6] state that the information exchange can only be authorized for the collection of tax and that FBAR "penalties" were not "taxes," per se. The taxpayer argued that the IRS had even violated its own rules because it allowed the release of his tax information without the Related Statute Determination required in the IRM.

However, contrary to the IRM, the court interpreted that 31 U.S.C. § 5314 (foreign transactions and bank accounts) is intrinsically a related statute to 26 U.S.C. § 6103 and operates in furtherance of tax administration. The court held that the administration of tax included penalties for non-compliant foreign reporting, and therefore deemed the exchange and utilization of information as permissible. It even set aside the IRM violation by the IRS employee under the IRS' own guidelines, citing the longstanding position that the IRM "confers no rights upon taxpayers."[7]

Taxpayers can no longer presume that documents directed to the IRS are for their eyes only. Despite the statutory protections instituted by Congress to maintain taxpayer confidence, information can be procured without authorization under the guise of effectuating tax administration by other divisions of the Department of the Treasury.

But then a question emerges…due to the fact that the penalty under the Patient Protection & Affordable Care Act was classified a "tax" by the US Supreme Court, will other agencies of government likewise obtain the ability to procure confidential tax return information without notice to Taxpayers? And in light of the recent GAO report declaring the intent to pursue "Quiet" FBAR filers, will reviewing Agents have free reign to cross-check with the income tax file(s) merely to scan for instances of culpable conduct?

The holding in *Hom* sets a dangerous precedent which spans beyond just the sharing of information for enforcement. It endorses the exposure of data to unintended parties and reduces the relevance of the IRM, the roadmap for Federal Tax controversy matters. Information sharing can trigger the erosion of privacy protections. And like the recent National Security Agency scandal, it produces the impression to taxpayers that the system lacks oversight and limitation. Looking ahead, these permissible privacy violations should be watched very closely as the government expands its involvement into the administration of other areas in our lives.

Eric L. Morgenthal, Esq., CPA, M.S. (Taxation) maintains his Tax Law practice in Melville specializing in International, Federal and NYS Tax Controversy Matters.

1. IRM § 1.17.2.3.5.
2. 26 U.S.C. 6103.
3. *See* IRM §§ 4.26.17.2 and 4.26.14.2.2.
4. *See* IRM 4.26.17.2
5. No. C. 13-02243 WHA, 2013 U.S. Dist. LEXIS 142818 (N.D. Cal. Sept. 30, 2013).
6. 26 U.S.C § 6103 (and the associated IRM sections).
7. *United States v. Caceres*, 440 U.S. 741 (1979).

SURTAX ...

Continued From Page 3

that the taxpayer was operating.

The following types of income are not considered to be investment income and are not subject to the 3.8% tax:

1. Active trade and/or business income.

a. The income must be earned in the trade or business[6] that the taxpayer is conducting.

b. The income must be earned in the ordinary course of the trade or business; therefore, investment income earned by the business would not be exempt from the Medicare surtax.

c. The trade or business cannot be passive to the taxpayer.

d. Income from the sale of an active business in which the owner is not passive.

2. Distributions from qualified retirement plans, including Individual Retirement Accounts.

3. Municipal bond income. When investors consider the rate of return on municipal bond income, they calculate the interest rate that they would need to generate to net to the interest rate on the municipal obligation. Let's say that a municipal obligation pays 3%. A taxpayer who is subject to the highest individual rate of 39.6% plus the new 3.8% NIIT, for a total of 43.4%, would need to purchase a taxable obligation paying 5.3% to net to 3% tax free. When you factor in the New York State income tax rate, the investor must earn more than 5.3% to net to the 3% tax free rate.

4. Social Security; life insurance; alimony; lottery and gambling winnings.

Deductions in Arriving at Net Investment Income

It makes sense that investment advisory and brokerage fees would constitute a valid deduction to reduce NII; however, it's not that simple because the IRC requires that most miscellaneous itemized deductions be reduced by what is referred to as a 2% floor, *i.e.*, reduced by 2% of AGI before allowing it as a miscellaneous itemized deduction.

Note that if the taxpayer is subject to the dreaded alternative minimum tax ("AMT"), which most New York State homeowners are, that negates a tax benefit for the deductible portion of the miscellaneous deductions; however, it still will be allowed as a deduction (to the extent that it exceeds 2% of AGI) in calculating the NIIT.

Deductible investment interest expense is a valid deduction for NIIT purposes.

Here's something new. State and local income taxes attributable to net investment income reduces the NIIT. Ah, but how is the allocated amount calculated? Per the proposed regulations, it's calculated on a 'reasonable' basis but the starting point for determining what is 'reasonable' is, according to the proposed regulations, the deduction on the tax return being filed on the cash basis (*i.e.*, the amount of state and local taxes paid in the calendar year).

Many commentators have opined that a more reasonable starting point should be the tax expense calculated on the taxpayer's state and local tax returns being filed for the calendar year (similar to the calculation of the credit on the New York income tax return for taxes paid to another state).

Pre-2013 (as well as current and future) net passive loss carryforwards reduce net passive net investment income in 2013 and thereafter but net operating losses, no matter when incurred, do not reduce net investment income on the theory that the NOL cannot be allocated to a specific type of income.

The IRS uses "difficulty" as a reason for not allowing the net operating loss carryforward to be factored into the calculation of net investment income. The New York State Society of Certified Public Accountants commented to the IRS state that "...it would be possible to track the portion of an NOL allocable to a net investment loss without creating rules that would be unduly complex and not administrable." Other organizations have submitted similar comments.

Although the net operating loss carryforward, for the time being, cannot be used to reduce NII, an NOL carryforward can be used in calculating the current year's AGI (perhaps to bring the taxpayer's AGI below the applicable threshold and avoid having to pay the NIIT).

Estates and Trusts

Fiduciaries have the responsibility to consider the interests of both the income beneficiaries and the remaindermen when making discretionary decisions. Beginning in 2013, the ordinary and capital gains (and qualified dividends) income tax rates on estates and trusts have increased (to 39.6% and 20%, respectively) and, because of the low threshold, as noted earlier, estates and trusts easily will be subject to the 3.8% Medicare surtax.

The NIIT is an additional danger area for fiduciaries' decision making. While the taxes on estates and trusts can be minimized by making distributions to beneficiaries who are eligible for a higher threshold before becoming subject to the Medicare surtax, the fiduciary needs to consider state law (*e.g.*, as a general rule, capital gains do not flow through a beneficiary except in the year that the estate/trust is terminated); the governing document (which may contain prohibitions on specified distributions); and the grantor's intent.

Also, state and local (*e.g.*, New York City) income taxes imposed on the recipient beneficiaries may be a consideration when deciding whether to make distributions where the estate/trust is in a state without an income tax. Additionally, beneficiaries who have capital loss carryforwards may want the capital gains to be distributed, if possible, since they will not incur the 20% capital gains tax and 3.8% NIIT (whereas gains trapped within the estate/trust will incur the 20% capital gains tax and 3.8% NIIT). Their share of the capital gains will be offset by their capital loss carryforwards.

Some disadvantages to beneficiaries receiving discretionary distributions, and the taxable income resulting therefrom, include a higher adjusted gross income which, inter alia, increases the 2%/3% floors on itemized deductions; has an effect on Roth and traditional IRA contribution limitations; has an effect on the amount of taxable Social Security; and has an effect on the oft-forgotten calculation of Medicare premiums of 'high earners.'

On August 7, 2013, the IRS issued, in draft form, the one-page Form 8960,[7] Net Investment Income Tax-Individuals, Estates, and Trusts. The form makes numerous references to "see instructions." The instructions are not expected out until after the regulations are finalized later in the year.

Further Guidance on the NIIT

The IRS has issued Q & A's which are understandable.[8] Also, many well-written articles have been published on the subject and many organizations (including the American Bar Association and the New York State Bar Association) have submitted comments to the IRS with suggestions as to how the proposed regulations should be changed.

The benefit to reading the comments is that they highlight the problems with interpreting the law and alert you as to matters that might be of interest to you. There also are sites, such as Google, to help you search for information of use to you.

Conclusion

Re-evaluate Federal tax estimates and alert the client if the 2013 Federal tax estimate should be increased or if a larger Federal tax balance will be due in April 2014.

… and finally, death cures the Medicare surtax (and capital gains tax) on gains unrecognized at the time of the death of the decedent (because the tax basis of most[9] assets is re-valued at death).

Alan E. Weiner, CPA, JD, LL.M. is Partner Emeritus of Baker Tilly (formerly Holtz Rubenstein Reminick) and was its founding tax partner (1975). He served as the 1999-2000 President of the New York State Society of CPAs. He is the author of *All About Limited Liability Companies and Partnerships* and DFK International's *Worldwide Tax Overview*.

1. The statute also imposes an additional tax of .009 on certain employees and self-employed individuals' earned income. This article is limited to the surtax on net investment income.
2. *See* 26 U.S.C. § Subtitle A. IRC § 1411 provides that it shall apply to taxable years beginning after December 31, 2012.
3. 77 Fed. Reg. 234 (Dec. 5, 2012).
4. Although commonly referred to as the Medicare surtax, the 3.8% tax collected is not earmarked for the Medicare Trust fund. Also, none of the 3.8% tax is deductible either as a medical deduction or as part of the self-employment tax deduction.
5. MAGI is the taxpayer's normal adjusted gross income on the Form 1040 plus income earned by the taxpayer while working outside of the country if the income is eligible to be excluded from taxable income under IRC section 911.
6. The proposed regulations do not define "trade or business," something that the IRS is reluctant to do. The IRS has said to look at cases and other regulations and perform a 'facts and circumstances' test.
7. http://www.irs.gov/pub/irs-dft/f8960--dft.pdf
8. http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs
9. 'Income in respect of a decedent' (*i.e.*, income earned before death but not yet collected, such as rental income) is not re-valued at death.

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WE CARE

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WE CARE wishes to especially thank

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WE CARE wishes to thank

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ARTrageous is Coming!

WE CARE's Second Annual Art Show and Cocktail Party is scheduled for Thursday evening, February 13, 2014, just in time for you to select an appropriate gift of art for your special someone. Save this date!

The First Annual ARTrageous event was a smashing success. More than 50 artists and photographers participated in our first art show, which offered more than 100 works of art for sale. Many of these were donated, providing WE CARE with 100% of the sale price as a donation. For those artists who chose to consign their work, WE CARE shared 50% of the sale price with the artist.

The event committee has promised a lavish cocktail party with a wonderful assortment of local wines. The cost of the event is $75 per person or $100 per person with a credit of $50 on any work of art purchased by that guest.

If you are an artist or know someone who is, tell that person about ARTrageous, suggest they join with their fellow professional and amateur artists to assist WE CARE in its charitable work; and, at the same time, introduce themselves to the local community. Every artist who submits work will be invited to be our guest at the event and provide brochures or information about themselves or their studio.

Be sure to make note of the date – Thursday, February 13, 2014. An invitation will be on its way to you shortly – via email or snail mail – and we hope you will respond early. Bidding on the art is by silent auction and great bargains are possible for the shrewd shopper.

WE CARE Fund is the charitable arm of the Nassau County Bar Association, created 25 years ago to aid the underserved populations of Nassau County, principally children, the sick, elderly and impoverished. Since its beginning WE CARE has awarded grants to charities of more than $4,000,000. ARTrageous is one of the WE CARE Fund's events that seeks your support for our mission.

Contact Sheryl Palley-Engel at the Bar Association (516) 747-4070 for more information and an application to participate.

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ARTrageous at the BAR

ARTrageous at the BAR
an Art Show & Cocktail Party
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"On the eve of Valentine's Day"

WE CARE is looking for artists who wish to donate works of art for sale or consignment (50/50).
Paintings, photography, pastels, prints...No sculptures, please.
Art from members' collections is also sought.

Send a photo, along with the size and medium of the donated or consigned art to wecare.artrageous@gmail.com

INCENTIVE ...

Continued From Page 5

and the health of future generations, to permanently protect their land while enjoying significant tax benefits. On Long Island, where property values are high, this deduction can result in significant tax savings.

Federal Tax Benefits

In 2006, through the Pension Protection Act,[3] Congress encouraged the donation of conservation easements by increasing the deduction from 30% to 50%, and extending the carry-forward period from five years to fifteen. This incentive widens the taxpayers that could benefit from the donation. While this incentive has help preserve thousands of acres across the country, the law sunsets periodically and is scheduled to sunset once again on December 31, 2013.

The federal tax benefits are depicted in the following example. A donor with an Adjusted Gross Income (AGI) of $500,000 who donates an easement with a conservation value of $3,500,000[4] could deduct $250,000 (50% of AGI) each year for a total of 13 years. This deduction could create significant federal income tax savings for landowners with income.

New York State Tax Credit

In addition to the federal tax benefits for donating a conservation easement, there is also an annual New York State tax credit that is worth mentioning. This credit offers New York taxpayers whose land is restricted by a conservation easement an annual state income tax credit of up to 25% of the school district, county and town real estate taxes paid on the restricted land, up to an annual maximum of $5,000 per taxpayer.

In order to qualify for this credit the easement must be voluntarily donated and comply with the requirements of IRC § 170(h). Moreover, the easement must be filed with the Department of Environmental Conservation.

Finally, unlike the federal deduction, this credit applies to easements donated prior to the 2006 enactment of the credit and stays with the property. In other words, future owners of the property would benefit from the qualified easement even though they did not donate the easement.

Donation Requirements

There are a few things to think about when discussing an easement donation with a client, as the IRC has specific requirements when seeking a charitable income tax deduction for donating a conservation easement. These requirements can be found in IRC § 170(h).

The IRC provides the donor of a "qualified conservation contribution"[5] to a "qualified organization"[6] exclusively for "conservation purposes"[7] is entitled to a deduction. According to the IRC, a conservation easement is a qualified conservation interest when the conservation easement is granted in perpetuity.[8] While this requirement is daunting to many landowners, it should be noted that conservation easements can be tailored to accommodate a landowner's current and future needs.

For example, if the landowner anticipates subdividing out two lots in the future in order to give to each of his two children that right can be written into the easement. Does the landowner want to add a pool down the road? Or what about an addition to their existing house? All of these things should be considered and discussed with the landowner prior to entering into the easement, keeping in mind that the more rights reserved for the landowner the less the conservation easement value.

Also important are the conservation values of the property that are being preserved. The IRS looks to this in establishing the purpose of the easement. The IRC defines what a qualifying purpose is. According to Section 170(h)(4), qualifying purpose can be described in four separate categories generally: (1) outdoor recreation or education for the general public; (2) protection of a relatively natural habitat; (3) the preservation of open space; or (4) the preservation of historically important land or certified historic structure.

When drafting conservation easement agreements, the "qualified purpose" should be clearly stated. Many landowners mistakenly think that donating a conservation easement over their property will open their land to the public. This is not usually the case. Most easements do not require public access, and actually granting public access may be an infringement of the conservation purposes, such as protection of a specific natural habitat.

Other matters to consider when contemplating a conservation easement are the value of the conservation easement. The IRS requires that the value of the easement be established by a "qualified appraisal"[9] which shall be conducted by a "qualified appraiser."[10] A qualified appraisal, among other things, must include a description of the property and the method of valuation used to determine the fair market value.

It should be noted that the appraisal cannot be completed more than 60 days prior to the date of the gift and must be completed no later than the due date for the landowner's federal tax return for the year in which the gift was made. Form 8283 needs to be signed by the appraiser to support the donation by the landowner and should be submitted with the appraisal.

Also, when contemplating an easement donation, any mortgages on the property will need to be subordinated to the easement in order to protect the perpetuity requirements of the deduction. Treasury Regulation Section 1.170A–14(g)(2) states that "no deduction will be permitted ... for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity."

The Conservation Easement Incentive and the New York State tax credit are valuable tools available to landowners looking to protect the conservation values of their property while simultaneously receiving significant tax benefits from the donation. As each landowner's situation is unique, the landowner's advisors should thoroughly review any future uses or development on the property. Also, it is important that the strict requirements are adhered to when donating an easement because the IRS may deny the deduction.

Elizabeth Baldwin is the Associate Director and Counsel for the North Shore Land Alliance, a not-for-profit land trust located in Old Westbury. For more information regarding conservation easement donation or the North Shore Land Alliance, contact the Land Alliance at (516) 626-0908 or e-mail Beth at bbaldwin@northshorelandalliance.org.

1. IRC §170
2. H.R. 2807.
3. The enhanced incentive was created in the 2006 Pension Protection Act, extended through 2009 in the 2008 Farm Bill, through 2011 by section 723 of H.R. 4853, and through 2013 by section 206 of H.R. 8.
4. Conservation Value is determined by determining the value of the entire property and deducting the value of the property with easement. The difference between the two values is the conservation value. For example, a property with an appraised value of $5,000,000 who donates a conservation easement thereby reducing the appraised property value to $1,500,000 has a Conservation Easement Value of $3,500,000.
5. IRC § 170(h)(1).
6. IRC § 170(h)(3).
7. IRC § 170(h)(4).
8. IRC § 170(h)(2)(C).
9. IRC § 170(f)(11)(E)(i).
10. IRC § 170(f)(11)(E)(ii).

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WINDSOR ...

Continued From Page 7

retroactive or only apply moving forward. The Revenue Ruling offers a favorable solution – providing prospective application, effective September 16, 2013, so that same-sex married couples must file as married for any returns filed after that date.

Couples who were legally married in prior years for which the statute of limitations is still open may, but are not required to, file amended returns to reflect their married status. In general, the statute of limitations for refunds runs three years from the date a return was filed or two years from the date the tax was paid, whichever is later.

The September 16 effective date is a little odd, considering that the due date for individuals filing 2012 returns who have received extensions was October 15. This means that same-sex couples who did not file their 2012 returns on or before September 15, 2013 were required to file as married; if filing before September 16, they were able to choose between married or single status for 2012 returns. Presumably, if one spouse had filed as single before the September 15 deadline but the other spouse had not filed by that date, both were required to file as married for 2012 and the earlier return would have to be amended.

Favorable or Not? It Depends

Whether married status is favorable for tax purposes is a matter of individual circumstances, and couples should consult their tax advisers to make an intelligent choice where there is an option, such as where amended returns could be filed, and to plan for the future.

Post-September 15, 2013, same-sex couples now face the same decisions faced by heterosexual couples: whether to file using married status or as married filing separately. Filing as married could trigger the so-called "marriage penalty" if both spouses have considerable income. They could pay more tax as a result of being taxed in a higher "tax bracket" at a higher rate.

In other cases, particularly where there is a large discrepancy in the earnings of the spouses, married filing separately will cause a higher combined tax bill. In addition to filing status, there are implications that must be considered, and that could affect the decision whether or not to file amended returns. For example, married couples are jointly liable for any tax due, unless "innocent spouse" relief is available.

Weighing Your Choices

Sitting down with a tax specialist to discuss the possible ramifications is important before filing any amended returns, as there are many thorny issues to consider. While, a detailed analysis is beyond the scope of this article, it is notable that the revenue ruling states that there are more than 200 provisions of the Internal Revenue Code that will be affected. The brief summary below addresses some of the most prominent questions.

Income Tax Issues

Filing status: The most obvious consequence of *Windsor* is that same-sex couples will be considered as "married" for filing status purposes, and will need to choose between filing a joint return or as married filing separately. As already noted, in many cases a joint return will result in a lower tax liability, and filing amended returns to claim refunds may make sense. In other cases, the so-called "marriage penalty" may cause a higher tax liability if married status applies. In addition, joint liability applies for returns filed as married.

ERISA/Employee benefit plans: *Windsor* will surely have a large impact on employee benefit plans under ERISA, where spousal status is important in determining the amount and timing of many benefits. For example, spousal consent could be required in order to choose certain forms of distribution.

Compensation/fringe benefits: Issues related to the taxation of employee compensation will arise. For example, an employer's contribution to health insurance coverage for a same-sex spouse will be nontaxable under *Windsor*, again raising the possibility of refunds. In addition, contribution limits to tax-favored compensation plans, such as flexible spending accounts, may be affected by marital status. In some cases this may be helpful, as with the ability to contribute to a spousal IRA. In other cases it may be a detriment; for example, the limit on contributions to a flexible spending account is $5,000 for both single people and married couples, so that same-sex couples may have over-contributed in prior years, resulting in additional tax.

Related party rules: There are many rules in the IRC which apply exclusively to "related" parties, and various attribution rules which apply in determining whether entities are related. For these purposes, attribution will apply between spouses in almost every case. Some same-sex couples had taken advantage of the fact that they were not defined as spouses for federal tax purposes to skirt the related party rule. These arrangements will now have to be re-thought.

Other tax provisions which will be directly affected by *Windsor* include those related to divorce, the higher exclusion available for married couples when selling a primary residence, and various credits, such as the earned income credit, child care credit and adoption credit.

Estate and Gift Tax Issues

Marital deduction: The *Windsor* case itself dealt with the availability of the estate tax marital deduction. Going forward, it is clear that same-sex couples will qualify for the unlimited marital deduction under both the federal estate and gift taxes. This may require same-sex couples to re-examine their wills. Again, refund claims may be advisable.

Portability of estate tax exclusion: Under current law, a surviving spouse may utilize any of the deceased spouse's unused estate tax exclusion.

Split gifts: Married couples can take advantage of "split gifts" so that each can take advantage of the annual gift tax exclusion.

FICA Issues

Non-taxable employee benefits: As already noted, certain compensations paid on behalf of an employee's spouse are not subject to FICA. To the extent the employer paid FICA on such income refund claims may be possible, both for the employer portion of FICA and on behalf of employees for the employee portion.

Sole proprietorship: Services performed by an employee in the employ of a spouse are not subject to FICA taxes, and any such tax paid by a sole proprietor on compensation paid by to a spouse in open years can be claimed for refund.

The IRS and the states are expected to issue additional guidance on the application of *Windsor* to federal tax issues. Until then, practitioners and their clients affected by *Windsor* would be well-served to review both income and estate tax planning to determine what changes may be needed. It is important to remember that the consequences will vary for differently-situated taxpayers; some will benefit while others may pay more tax. Where it makes sense, refund claims should be filed. In any case, the time to take action is at hand.

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1. 570 U.S. ____, 33 S.Ct. 2675 (2013).
2. 1 U.S.C. § 7 and 28 U.S.C. § 1738C.
3. Rev. Rul. 2013-17, 2013-38 I.R.B. 201.
4. Rev. Rul. 58-66, 1958-1 C.B. 60.

STUDENT LOANS ...

Continued From Page 9

of IBR.

However, for debtors who experience prolonged periods of unemployment or underemployment, especially those who exit school with large initial loan balances, the total outstanding balance of their student loans may accumulate to an unmanageable level under IBR. In any case, the cancellation of indebtedness income from forgiveness under IBR will prove even more problematic if debtors have not been adequately informed of its existence, thus precluding their ability to prepare accordingly.[17]

Student loan debtors may view IBR as an attractive repayment option for their student loans, but they should consider the tax consequences of opting for IBR before doing so. The concept of forgiveness after 25 years of timely payments may mislead student debtors into believing that they would owe nothing further after their debts are cancelled, especially in light of the government's omission of in-depth tax information from their IBR resources. The IRC, however, provides differently. When considering repayment options, student loan debtors should pay heed to the tax consequences of IBR.

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1. Tamar Lewin, *U.S. to Contact Borrowers With New Options for Repaying Student Loans*, N.Y. Times, Sept. 24, 2013, at A20.
2. 20 U.S.C. § 1098(e).
3. *See, e.g.*, Lewin, *supra* n.3. *See also* Megan Slack, *Income Based Repayment: Everything You Need to Know*, The White House Blog, (June 7, 2012), http://www.whitehouse.gov/blog.
4. *Id.*
5. Jonathan M. Layman, *Forgiven But Not Forgotten: Taxation of Forgiven Student Loans Under the Income-Based-Repayment Plan*, 39 Cap. U. L. Rev. 131, 152–53 (2011).
6. After July 1, 2014, IBR payments will be capped at 10% of the taxpayer's disposable income, and loans will be eligible for cancellation after twenty years instead of the current twenty-five. The White House, *Ensuring that Student Loans are Affordable*, available at www.whitehouse.gov. *See also Layman*, supra n.7, at 152.
7. *See Layman, supra* note 7 at 139 (*citing* 34 C.F.R. § 682.215(b)(1) (2009)) (stating that the only requirement to qualify for complete forgiveness is partial financial hardship).
8. IRC § 61(a).
9. IRC § 61(a)(12).
10. 284 U.S. 1, 52 (1931).
11. IRC § 108.
12. IRC § 108(a).
13. IRC § 108(f).
14. *See generally* IRC § 108(f).
15. *See, e.g., Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 93 (4th Cir. 1985).
16. Phil Izzo, Class of 2013, Most Indebted Ever, WALL ST. J. BLOG (May 18, 2013, 5:00 AM), available at http://blogs.wsj.com.
17. *See* n.5, *supra*.

GST ...

Continued From Page 9

direct skip).[6] This would occur, for example, when a trustee makes a distribution from a trust to a grandchild.

A taxable termination, on the other hand, occurs when there are no more non-skip persons ahead of the skip person because, for example, of the non-skip person's death, release of a power, lapse, etc., unless (1) immediately after the termination a non-skip person has an interest in the trust or (2) at no time after the termination may a distribution be made from the trust to a skip person.[7]

Transfers to Trusts

The annual GST exclusion, while quantitatively the same as the annual gift exclusion, only applies to outright transfers to direct skip persons or transfers in trust for the benefit of a skip person who, if he or she dies prior to the termination of the trust, will have the trust assets included in his or her estate.[8] When the annual gift and GST exclusion applies one does not need to file a gift tax return. But what if neither of these scenarios applies to the transfer?

This is most frequently seen with Crummey trusts because the power holders are often non-skip and skip persons. For this reason, with irrevocable life insurance trusts, it is preferable to elect out of the automatic allocation rules and periodically allocate GST exemption on Form 709.

It also comes into play when there is an Estate Tax Inclusion Period ("ETIP"), such as with Qualified Personal Residence Trusts ("QPRT"), Grantor Retained Annuity Trusts ("GRAT") or reverse qualified terminable interest property, because again, the automatic allocation rules may apply but the exemption will not be effective until after the ETIP ends.[9] The taxpayer is taking a risk by applying his or her GST exemption to property whose value is unknown until the ETIP terminates.[10]

When there is a taxable event, such as, a distribution to a skip beneficiary or a termination in favor of a skip beneficiary, GSTT is imposed based on the amount of GST exemption allocated to the trust or direct skip. With the allocation of GST exemption, the GSTT is reduced or eliminated by the inclusion ratio. The inclusion ratio is the fraction of the transfer (up to the whole) sheltered from tax by the GST exemption allocation.[11]

The goal is to always have an inclusion ratio of one (the entire transfer is subject to GSTT) or zero (none of the transfer is subject to GSTT). When the inclusion ratio is some fraction of the transfer then a fractional share of the transfer is taxable. Once one knows the inclusion ratio, one knows the tax rate, (*i.e.*, the maximum transfer tax rate multiplied by the inclusion ratio).

For example, if the entire transfer to a trust is equal to and allocated one's available GST exemption, then the tax rate is zero and no GSTT is imposed on the trust corpus, including appreciation and accumulated income. This is significant because the allocation of GST exemption is applied to the entire trust, not select assets. Ultimately the inclusion ratio does not exempt the assets from tax, it simply determines the tax rate applicable to each taxable event (direct skips, distributions or terminations).

Automatic Allocation

GST exemption is automatically allocated to gifts (1) that are direct skips, and (2) GST trusts. IRC §2632(c)(3)(B) broadly defines a GST trust as one that can have GSTT. It goes on to provide four exceptions in which the automatic allocation of GST exemption will not occur. It is evident that the intention of this section was to provide a means of preventing a taxpayer and his or her advisor from allowing GST exemption to be automatically allocated to trusts that were never intended to benefit skip persons. Thus, the automatic allocation of GST exemption does not occur when:

A. the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons –

1. before the date that the individual attains age 46,

2. on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or

3. upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46,

B. the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals,

C. the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (i) or (ii), more than 25 percent of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals,

D. the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer,

E. the trust is a charitable lead annuity trust (within the meaning of IRC § 2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of section 664(d)), or

F. the trust is a trust with respect to which a deduction was allowed under IRC § 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate."[12]

Clearly, a review of the above demonstrates that the automatic allocation rules are difficult to comprehend and, if not carefully considered, can result in an unintended, and sometimes severe tax consequence.

For example, frequently individuals create trusts for their lifetime and upon their death and/or the death of their spouse, the trust continues until their children have reached specific ages. A review of IRC § 2632(c) might lead one to incorrectly assume that one's GST exemption is not going to be automatically allocated to this type of trust. But the death of a parent may not be reasonably expected to occur before a child has attained the age specified in the IRC.

Furthermore, in our example, the trust assets are not distributed upon the death of the parent but rather held in further trust. Therefore, unless one affirmatively elects out of automatic allocation, one's GST has just been wasted on a non GST trust.

The example above demonstrates that the automatic allocation rules can be overly broad and do not take into consideration where one's GST exemption allocation would be most beneficial. In addition, the automatic allocation of one's GST exemption is irrevocable once the due date, including extensions actually granted, for reporting the taxable gift has passed.[13]

To preserve one's ability to make late elections to a GST trust, one must elect on a yearly basis out of the automatic allocation as to one's trust or elect to not have the automatic allocation rule apply on any future transfer to that trust.[14] When one elects out of the automatic allocation there is an increased ability to plan with one's GST exemption as well as with the trust document involved. Because, as with everything, eventually there will be no more GST exemption to allocate and it is always better that the taxpayer understands that before he or she receives a tax bill.

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1. IRC §2652.
2. IRC §2652 (a)(2).
3. IRC §2613(a).
4. IRC §2613 (a)(2).
5. IRC 2632(c)(3).
6. IRC §2612(b).
7. IRC §2612(a)(1).
8. IRC §2642(c).
9. IRC §§2632(c)(4); 2642(c)(4) and (f); Regs. §26.2632-1(b)(2) and 1(c).
10. Regs. §26.2632-1(c)(1).
11. IRC §§2602, 2641, 2642.
12. IRC §2632(c).
13. Regs. §26.2632-1(b)(1)(ii).
14. IRC §2632(c).

TRANSFERS ...

Continued From Page 11

the gain or as much as 20% in taxes.[6]

Upon the death of the life tenant, if the property was not sold, the remainderman will receive basis in the property equivalent to the fair market value of the property as of the life tenant's date of death. This "step up" in basis will eliminate capital gains tax for the remainderman if the house is sold before the house value appreciates further.

Transfers to A Medicaid Asset Protection Trust

Transferring a residence to a Medicaid Asset Protection Trust, or MAPT, is gaining popularity among many homeowners because it offers significant protections and tax advantages.

The MAPT is an irrevocable trust, meaning the grantor transfers the residence into the trust relinquishing his or her ownership rights. This is important because, for Medicaid purposes, a transfer must be a divestment of property and the grantor cannot have access to the principal of the trust.

When a residence is transferred into a MAPT, the five-year look-back period for Medicaid is triggered. Once the look-back period has expired, the transfer of the residence is no longer an issue for Medicaid eligibility purposes. If the residence is sold during the grantor's lifetime the proceeds from the sale will replace the house ownership as a trust asset. The net proceeds remain in the MAPT with the same look-back period issues.

The MAPT is an Intentionally Defective Grantor Trust. The grantor trust rules, as provided in sections 671 through 679 of the IRC, identify several provisions that result in grantor trust status. Once grantor trust status has been established, the grantor, for income tax purposes, is treated as the owner of the trust assets. Any income earned by the trust is taxed to the grantor.

In addition, certain real estate tax benefits remain intact with the use of a MAPT. MAPT's are drafted using one or more grantor trust provisions: a limited power of appointment,[7] the power of the grantor to reacquire the trust corpus by substituting other property of an equivalent value,[8] and distribution of income to the grantor.[9]

The MAPT often gives the grantor a life interest in the residence which guarantees the grantor the right to reside in the home. The grantor can also redirect how the trust assets are to be disposed of at death by including a limited power of appointment in the trust.

The MAPT can be drafted so there are no gift tax consequences. If, by its terms, the transfer of assets into the trust is a completed gift, then it is subject to gift tax and a federal gift tax return must be filed even if no gift tax is due. If the transfer is an incomplete gift,[10] then the transfer of assets into the trust does not require the filing of a gift tax return. If the gift is incomplete or the grantor has retained powers over the trust property under Section 2035 through 2042 of the IRC, then the trust property is includable in the taxable estate. This inclusion is desirable as it results in a "stepped up" basis in the property equivalent to the fair market value of the property as of the grantor's date of death.

Since the MAPT is drafted to achieve grantor trust status, the grantor retains his or her capital gains tax exclusions. Therefore, when a home transferred into a MAPT is sold during the grantor's lifetime, the grantor's capital gains exclusion can still be applied, reducing or eliminating capital gains tax.

Using the previous example, if Mom transferred her home into a MAPT with daughter as the ultimate beneficiary, Mom can apply her capital gains exclusion of $250,000 to the entire gain of $450,000. If the house is not sold during the life of the grantor, then upon the death of the grantor the remainder beneficiaries of the MAPT receive a basis equivalent to the fair market value of the residence on the grantor's date of death.[11] If Mom dies before her residence is sold, then daughter, as the sole trust beneficiary, will inherit the house with a basis of $500,000. If daughter sells the house before it appreciates in value, she will not incur a gain tax.

The MAPT has an additional benefit, as it can be drafted to allow the trust to be voided should the grantor need nursing home care prior to the expiration of the five-year look-back period. However, Section 7–1.9 of New York's Estates, Powers and Trust Law requires the written consent of "all the persons beneficially interested in a trust" to revoke the trust.

Maximum flexibility is needed when creating a plan to protect a client's assets for future long term care needs. There are several methods available when considering the most appropriate way to protect the value of one's home. Each method requires careful consideration as they all come with their own tax implications. A review of the Medicaid rules, the transfer methods available, and the associated tax consequences, with each client is essential for proper planning.

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1. For 2013 income and resource levels, see 2013 Medicaid Only Income and Resource Levels and Spousal Impoverishment Standards, GIS 13/MA 02, at 2 (2013), available at www.health.ny.gov.
2. 18 N.Y.C.R.R. § 360-4.4(c)(1)(i), (iii); *see also* Deficit Reduction Act of 2005, Pub. L. No. 109-171, 11 Stat. 4 (2006).
3. 26 U.S.C. § 121(a).
4. 26 U.S.C. § 121(d)(7).
5. *See* 26 C.F.R. § 25.2511-2(b) for definition of completed gift.
6. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 U.S. Stat. 2313 (2012).
7. 26 U.S.C. § 674(a).
8. 26 U.S.C. § 675(4)(c).
9. 26 U.S.C. § 677(a).
10. *See* 26 C.F.R. § 25.2511-2(c) (defining an "incomplete gift").
11. 26 U.S.C. § 1014(a)(1).

1031 EXCHANGE ...

Continued From Page 11

exchange. The court distinguished this case from *Goolsby*, on the basis that:

- The loan application for the Reesinks' mortgage stated that the property was being acquired for investment purposes;
- The Reesinks posted flyers throughout the local area advertising the property for rent and placed signs at the property;
- The property was shown to at least two potential renters, both of whom declined to rent the property;
- The Reesinks did not sell their primary residence until 6 months after they acquired the replacement property;
- The Reesinks testified that they had no intention to move into the property prior to the exchange, and only did so because of financial difficulties;
- Mr. Reesink's brother testified that Mr. Reesink had discussed moving into the property, but that he would only do so after his children graduated from high school. The couple's oldest child was only 14 years old at the time of the exchange, and thus would not graduate high school for several years. While the testimony of a relative would appear to be self-serving, the court noted that Mr. Reesink and his brother had been involved in a contentious partition litigation, that the brothers had had several physical altercations, and that the brother was alleged to have poisoned Mr. Reesink on one occasion. (After dealing with his brother, Mr. Reesink was apparently well equipped to fight the IRS); and
- Mrs. Reesink also testified that she was very upset about moving from their residence in San Francisco and had considered leaving Mr. Reesink as a result.

Adams v. Commissioner, TC Memo 2013-7 (2013). The tax court permitted Adams to exchange a rental house in San Francisco for a house in Eureka, California, even though he subsequently rented the house to his son at a below-market rent. The court found that Adams held the property for investment and that the lower rent was fair and justified because:

- The house was dilapidated when it was acquired;
- Adam's son was a contractor who spent three months working 60 hours per week renovating the house at his own expense, including repairing mold damage, renovating and re-plumbing the kitchen and laundry room, replacing electrical fixtures and appliances, exterminating rats, and even chasing away a bear on one occasion. (It does not appear that the son considered whether the bear may have just been checking the smoke detectors, or that it was protecting the house from a certain blonde intruder with an affinity for porridge);
- While the rent of $1,200 per month was less than the rent for comparable properties in the area, unlike other renters, Adams' son and his family were responsible for continuing to renovate and maintain the property.

Yates v. Commissioner, TC Memo 2013-28 (2013). The tax court rejected an exchange for a replacement property that the Yates characterized as a bed and breakfast. The court noted the following issues to be significant in their determination:

- The only evidence of the Yates' intent to use the property as bed and breakfast was their uncorroborated testimony that they sought to have the seller of the property apply for this use and included a clause to this effect in the contract;
- There was no evidence that an application to use the property as a bed and breakfast was actually made, or that Yates even inquired about the seller's satisfaction of the "nonobligatory term of the contract";
- The Yates closed on the sale of their primary residence three days after the replacement property was acquired and immediately moved into that property.

The *Yates* case is also interesting because the taxpayer sold two relinquished properties in the exchange: their former primary residence ("Lakeview" property), and a restaurant called the Hula Grill. These properties were sold to the same buyer, who really only wanted the Hula Grill, but agreed to also acquire the Lakeview property because Yates insisted the properties be sold as together as a package.

The IRS accused Yates of inflating the value of the Lakeview property, where they could exclude up to $500,000 of gain under IRC §121, and deflating the value of the Hula Grill, since under IRC §1031 the capital gain could only be deferred, not excluded.

On this issue, the court ruled in the Yates' favor, finding that Yates and his buyer had adverse tax motivations and that they negotiated the purchase price allocation at arm's length. They noted that the allocation also affected the buyer's tax circumstances and that as a knowledgeable businessman, he would not have agreed to the allocation unless his interests were adequately represented.

These four cases show that it is difficult to determine bright line rules on whether a property has been used for business or investment use and would therefore be acceptable property to include in a 1031 exchange. The determination continues to be highly fact specific. However, given the number of recent cases litigating this issue, it appears that this topic is one the IRS will scrutinize. As such, taxpayers involved in 1031 exchanges would be wise to maintain documentation and records to substantiate their use of their property for productive use in a trade or business or for investment. Having a bear or a violent brother in your arsenal cannot hurt.

Michael S. Brady, Esq. is a Certified Exchange Specialist® and General Counsel to Riverside Abstract LCC and Riverside 1031 LLC.

1. IRC §1031(a).
2. *Moore v. Commissioner*, T.C. Memo. 2013-28 (2013).

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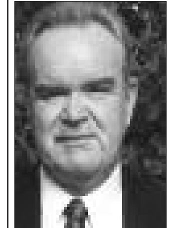

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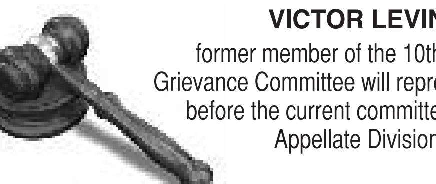

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- Author, Chapter on Alternative Dispute Resolution, Matthew Bender, New York Civil Procedure, Matrimonial Actions-1997
- Chairperson (1993-1996) Nassau County Bar Association Committee on Alternative Dispute Resolution
- 27 years of mediation/collaborative law experience

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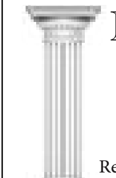

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