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To Live and Die in New York

A Review of the Recent New York Tax Law Changes Affecting Estate Planning and Trusts

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On April 1, 2014, Governor Andrew Cuomo signed into law as part of the New York State Executive Budget what might appear at first blush to constitute sweeping changes affecting estate planning and trusts. The new law, however, falls far short of achieving the laudable objective that Governor Cuomo had specified in his State of the State address of keeping wealthy New Yorkers in the Empire State during their golden years. Although the new law does indeed accomplish the important goal of increasing the New York estate tax exemption -- it now stands at $2,062,500 for persons dying between April 1, 2014 and March 31, 2015 and is scheduled to increase over time to match the federal applicable exclusion amount (currently $5,340,000) by 2019[1] -- there is an effective "cliff" within the new estate tax law that snatches away all of the benefits of the "tax-free zone" by imposing a marginal tax rate substantially in excess of 100% until all of the benefits of the tax-free zone have been undone.

The effect of this cliff – which in technical terms is accomplished through a hyper-accelerated phase-out of the applicable credit amount for New York taxable estates that are between 100% and 105% of the basic exclusion amount[2] – is to render illusory any hoped for New York estate tax savings for persons dying with taxable estates in excess of 105% of the "tax-free zone." Thus, a New Yorker who dies on April 1, 2014 with a taxable estate of $2,165,625 (105% of $2,062,500) will pay New York estate tax of $112,050, even though the taxable estate has exceeded the basic exclusion amount by only $103,125.[3] ***That dynamic produces an effective marginal estate tax rate of approximately 109%.***[4] This marginal estate tax rate gets even higher in subsequent years due to the mathematics involved as the basic exclusion amount increases from year to year, traversing into higher marginal tax rates that would otherwise be soaked up by the applicable credit amount.

But if one were to regard this dynamic as merely warranting a no-harm no-foul conclusion that wealthy New Yorkers are in the same

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position for New York estate tax purposes as they were prior to April 1, 2014, such an outlook would be sorely mistaken. In fact, wealthy New Yorkers whose taxable estates are more than 5% above the basic exclusion amount are potentially ***worse off*** under the new law compared to the old law. How so? Although the top New York State estate tax rate has remained at 16%[5] (instead of being reduced to 10% as Governor Cuomo had proposed), the new law tags for addback taxable gifts that New Yorkers make after March 31, 2014 while a resident of New York State during the three-year period immediately preceding their death (and prior to January 1, 2019).[6] Significantly, this potential addback also applies to post-March 31, 2014 gifts of real and tangible property located *outside of New York State* – even though such property would not be subject to the New York estate tax if the donor were to die the very next day. So wealthy New Yorkers with taxable estates that are more than 5% above the tax-free zone will be worse off than they were under prior law if they make taxable gifts after March 31, 2014 during the 3-year period immediately preceding their death.

But that's just the beginning. To compound this, it is questionable whether this addback component for certain lifetime taxable gifts would be deductible for federal estate tax purposes under Section 2058 of the Internal Revenue Code, which applies to state death taxes. To be deductible under IRC § 2058, the state death tax must be paid "in respect of any property included in the gross estate . . . ." An added-back gift that is not part of the federal gross estate would not seem to meet this definition. What this means is that wealthy New Yorkers may well be ***penalized for federal estate tax purposes*** for having lived and died in New York.[7]

And Now Introducing the Throwback Tax

The foregoing discussion does not even begin to address the nightmarish accounting aspects of tracking and computing New York's introduction of a "throwback tax" on certain distributions to New York resident beneficiaries from trusts qualifying for the "New York Resident Trust Exception" (other than so-called "incomplete gift nongrantor trusts" ("ING Trusts"[8])). The New York Resident Trust Exception applies to nongrantor trusts for which (1) all of the trustees are domiciled outside of New York State; (2) all real and tangible trust property is located outside of New York State; and (3) all trust income and gains is derived from sources outside of New York State.[9]

The throwback tax is extraordinarily complicated both in its statutory formulation (which relies upon extensive cross-references to unrelentingly complex provisions of the Internal Revenue Code that have been effectively repealed except in the case of foreign nongrantor trusts) and in its daunting practical application. Stated as a vast oversimplification, the throwback tax applies to income (1) of a trust qualifying for the New York Resident Trust Exception (2) which is distributed to a New York resident beneficiary (3) that was not previously taxed by New York and (4) that has been accumulated during taxable years beginning on or after January 1, 2014 for which there was a New York resident beneficiary who was at least twenty-one years of age.[10]

Other More Benign Aspects of the New Law

Other more benign aspects of the new law include the following:

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■ Valuation: The New York gross estate shall be valued as of the time of the decedent's death, except that if a federal estate tax return is filed and alternate valuation is elected for federal estate tax purposes, the New York estate must also be valued as of the federal valuation date. If such alternate valuation date could have been elected but for the absence of an estate sufficiently large to require the filing of a federal estate tax return, the New York estate may be valued as of the federal valuation date that would have applied if a federal estate tax return had been filed. However, no such election may be made unless it will decrease the value of the New York gross estate and the amount of New York estate tax.[11]

■ QTIP Election: The qualified terminable interest property ("QTIP") election will not be allowed unless such election was made with respect to a federal estate tax return that was required to be filed. If such election is made for federal estate tax purposes, then such election must also be made for New York estate tax purposes. ***However, where no federal estate tax return is required to be filed, a New York QTIP election is permitted.***[12]

■ Repeal of the New York GST Tax: The New York generation-skipping transfer ("GST") tax, which had applied to taxable distributions and taxable terminations from a trust to a "skip person" for GST tax purposes, has now been repealed.

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[1] The New York estate tax exemption amount under the new law is as follows:

- $2,062,500 for decedents dying between April 1, 2014 and March 31, 2015;
- $3,125,000 for decedents dying between April 1, 2015 and March 31, 2016;
- $4,187,500 for decedents dying between April 1, 2016 and March 31, 2017;
- $5,250,000 for decedents dying between April 1, 2017 and December 31, 2018; and
- The federal basic exclusion amount for decedents dying on or after January 1, 2019.

[2] New York Tax Law § 952(c)(1) provides (emphasis added):

A credit of the applicable credit amount shall be allowed against the tax imposed by this section as provided in this subsection. In the case of a decedent whose New York taxable estate is less than or equal to the basic exclusion amount, the applicable credit amount shall be the amount of tax that would be due under subsection (b) of this section on such decedent's New York taxable estate. **In the case of a decedent whose New York taxable estate exceeds the basic exclusion amount by an amount that is less than or equal to five percent of such amount, the applicable credit amount shall be the amount of tax that would be due under subsection (b) of this section if the amount on which the tax is to be computed were equal to the basic exclusion amount multiplied by one minus a fraction, the numerator of which is the decedent's New York taxable estate minus the basic exclusion amount, and the denominator of which is five percent of the basic exclusion amount. <u>Provided, however, that the credit allowed by this subsection shall not exceed the tax imposed by this section, and no credit shall be allowed to the estate of any decedent whose New York taxable estate exceeds one hundred five percent of the basic exclusion amount.</u>"**

[3] This is the difference between $2,165,625 and $2,062,500.

[4] $112,050 / $103,125 = 1.0865, which rounds to 109%.

[5] For decedents dying between April 1, 2014 and March 31, 2015, the top New York State estate tax rate is 16% and applies to taxable estates

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over $10,100,000. Interestingly, the new law does not indicate what tax rates would apply for persons dying after March 31, 2015. It can therefore be expected that this will be taken up in negotiations in connection with next year's budget.

[6] *See* N.Y. Tax Law § 954(a)(3).

[7] This tax trap could potentially be corrected if the New York Legislature were to amend Section 13-1.3 of the New York Estates, Powers and Trusts Law to statutorily treat the estate tax attributable to the taxable gift addback as a debt allocable to the residuary estate, except as may be otherwise provided in the deed of gift, Will or other governing instrument. *See Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

[8] Much less controversial, the new law subjects New York grantors of ING Trusts qualifying for the New York Resident Trust Exception to New York income tax by treating such trusts as grantor trusts for New York income tax purposes. *See* N.Y. Tax Law § 612(b)(41). Section 9 to the budget bill which enacted this statute provides that this provision does not apply to income from a trust that is liquidated before June 1, 2014.

[9] *See* N.Y. Tax Law § 605(b)(3)(D).

[10] *See* N.Y. Tax Law § 612(b)(40). Section 9 to the budget bill which enacted this statute provides that this provision does not apply to income that is paid to a beneficiary before June 1, 2014.

[11] *See* N.Y. Tax Law § 954(b).

[12] *See* N.Y. Tax Law § 955(c).

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