To Live and Die in New York (the Tax Department's Sequel)

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The New York State Tax Department's Guidance on the 2014 New York State Estate Tax Law Changes

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On August 25, 2014, the New York State Department of Taxation and Finance (the "New York Tax Department") issued TSB-M-14(6)M to provide guidance on the significant changes in the New York State estate tax system that became effective on April 1, 2014 (the "Tax Department's Estate Tax Guidance"). In its guidance, the New York Tax Department clarified certain points left open by the language of the April 1st statute concerning whether the potential addback for taxable gifts made after March 31, 2014 include gifts of real or tangible personal property having a location outside of New York State (it does not) and whether an estate tax return filed solely for purposes of electing portability of the deceased spouse unused exclusion amount is deemed an estate tax return that is "required to be filed" so as to warrant conforming qualified terminable interest property ("QTIP") elections for federal and New York State estate tax purposes (it is).

The Tax Department's Estate Tax Guidance, however, illustrates just how far the recent New York estate tax law changes miss the mark in 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. This statutory disparity provides the overarching backdrop to a review of the Tax Department's Estate Tax Guidance.

The Basic Exclusion Amount and Estate Tax Rates

The basic exclusion amount is used to determine the estate's filing threshold and also to determine the amount of the applicable credit (if any). The basic exclusion amount 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.

A graduated tax rate table applies based on the New York taxable estate of the New York resident or nonresident decedent. For persons dying between April 1, 2014 and March 31, 2015, the top marginal estate tax rate is 16%, and applies to New York taxable estates in excess of $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.

The Applicable Credit Amount and How New York's Estate Tax Cliff Works

Although the new law does indeed accomplish the 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 -- 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[1] – 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."

The New York Estate Tax Guidance provides an example where an individual dies with a taxable estate of $2,100,000, which is $37,500 above the "tax-free zone" of $2,062,500 for persons dying between April 1, 2014 through March 31, 2015. This produces a New York estate tax of $49,308, which computes to a marginal estate tax rate of more than 131% on the amount of the taxable estate in excess of the "tax-free zone" ($49,308 / $37,500 = 1.3149, which rounds to more than 131%). 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.

New York Taxable Estate for Residents

The Tax Department's Estate Tax Guidance confirms, as expected, that the New York taxable estate for the estate of any individual who was a New York State resident at the time of his or her death is the New York gross estate minus the deductions allowable for determining the federal taxable estate, except to the extent that any such deductions relate to real or tangible personal property located outside of New York State. The New York gross estate of a deceased resident, in turn, does not include any real or tangible personal property located outside of New York State.

Significantly, New York law does *not* adopt the federal estate tax concept of portability of the deceased spouse unused exclusion amount.

Where things get particularly interesting is in the addback for New York taxable gifts made after March 31, 2014. 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), provided that such gifts were not otherwise included in the individual's federal gross estate.[2] There was much concern based on the language of the statute whether such post-March 31, 2014 gifts made by a New York resident would be included in this taxable gift addback if the gift consisted of real or tangible personal property ***located outside of New York State*** – significantly, such property would not be subject to the New York estate tax if the donor were to die the very next day. Fortunately, the New York Estate Tax Guidance has clarified that such gifts of real or tangible personal property located outside of New York State are not added back for purposes of the New York estate tax.

Although this clarification is welcome, it does not address the underlying conceptual problem inherent in New York's taxable gift addback, which represents a marked departure from prior New York law. Simply put, wealthy New Yorkers with taxable estates that are more than 5% above the tax-free zone of the New York applicable exclusion amount will be worse off than they were under prior law if they make taxable gifts after March 31, 2014 (and prior to January 1, 2019) 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.[3]

New York Taxable Estates for Nonresidents

The New York taxable estate for the estate of an individual who was a nonresident at the time of his or her death will be computed in the same manner as the New York taxable estate for the estate of a resident, except that it does not include:

- the value of any intangible personal property otherwise includible in the deceased individual's New York gross estate; and
- the amount of any gift otherwise includible in the New York gross estate of a resident, unless the gift was made while the nonresident individual was a resident of New York State and consisted of real or tangible personal property having a location in New York State or intangible personal property employed in a business, trade or profession carried on in New York State.[4]

Filing Requirements – dates of death on or after April 1, 2014

The estate of an individual who was a New York resident must file a New York estate tax return if the federal gross estate, increased by the amount of any gifts includible in his or her New

York gross estate, exceeds the basic exclusion amount applicable to the date of death.

The estate of an individual who was a New York **nonresident** must file a New York estate tax return if the federal gross estate, increased by the amount of any gifts includible in the New York gross estate, exceeds the basic exclusion amount applicable to the date of death, and the estate included any real or tangible personal property located in New York State.

Alternate Valuation

The value of the New York State gross estate is determined at the time of the individual's death, and is the same as the federal gross estate amount. However, if the estate elected alternate valuation under IRC section 2032 on the federal estate tax return, the New York gross estate will be valued as of the applicable federal valuation date.

If a federal estate tax return is not required to be filed, but the alternate valuation could have been elected, the estate may elect to use the alternate valuation for determining the value of the New York gross estate. However, this election will not be allowed unless it decreases both the value of the New York gross estate and the amount of tax imposed reduced by any credits allowed. The election must be made no later than the due date of the return (including extensions) or at any time thereafter as may be allowed by the commissioner. Once the election is made, it is irrevocable.

Qualified Terminable Interest Property Election

If the qualified terminable interest property election was made for purposes of the federal estate tax return under the Internal Revenue Code, the election must also be made by the executor on the New York return. If, however, no federal return was required to be filed, the executor may still make the election for New York State purposes on a pro forma federal return attached to the New York return. Once the election is made, it is irrevocable.

Federal Elections

Elections made or waived on a federal estate tax return will be binding on a New York estate tax return. If a federal estate tax return is required to be filed and the right to any federal estate tax deduction is waived on the federal return, it is also waived for New York estate tax purposes.

The New York Estate Tax Guidance provides that a federal estate tax return is considered "required to be filed" when a deceased individual's gross estate exceeds the federal filing threshold. Moreover, this conclusion will obtain when the filing of the federal estate tax return is the only means for claiming certain tax treatment, such as claiming portability of the deceased spouse unused exclusion amount for federal estate tax purposes. This last point impresses this author as illogical, because although a federal estate tax return is indeed required to be filed in order to make a portability election, the executor of an estate below the threshold for having to file a federal estate tax return would not be in violation of federal tax law if he or she simply chose not to file a federal estate tax return to make a portability election, or otherwise inadvertently failed to do so.

The New York Estate Tax Guidance also addresses elections concerning the claiming of deductions for administration expenses, and casualty losses, on either the estate tax return or the fiduciary income tax return (but not on both). In this

situation, if a federal deduction for administration expenses or a casualty loss is claimed on the estate's federal fiduciary income tax return, then no deductions for such items can be taken on the New York estate tax return. This applies regardless of whether a federal estate tax return was required to be filed.

Effect on the New York State estate tax forms

Finally, the New York Estate Tax Guidance notes that the Tax Department will issue a revised version of Form ET-706, *New York State Estate Tax Return*, to be used for dates of death on or after April 1, 2014, and before April 1, 2015. For dates of death in 2014 prior to April 1, 2014, estates should file Form ET-706, *New York State Estate Tax Return – For estates of individuals with dates of death on or after January 1, 2014 and before April 1, 2014.*

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[1] 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. 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."**

[2] *See* N.Y. Tax Law § 954(a)(3).

[3] 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).

[4] An exception applies to exclude certain works of art that are loaned to (or en route to or from) a public gallery or museum in New York State solely for exhibition purposes at the time of the individual's death.

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