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Trusts and Estates

ALERT

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Important Changes Proposed to New York Estate Tax and New York Income Taxation of Trusts, Grantors and Beneficiaries

Important legislation has been introduced by New York Governor Andrew Cuomo that, if passed, would substantially change the New York estate tax regime and would also significantly change the income tax rules regarding certain trusts and their grantors and beneficiaries. As discussed below, some of the proposed changes may make it advisable to take prompt action—before the changes become effective.

Please note that the proposed legislation may undergo substantial changes before being enacted. The discussion below reflects recent amendments made to the proposals. As the proposals may be further amended any number of times before they are passed into law, please be sure to check with us before acting on any recommendations in this client alert.

Proposed Estate Tax Changes

The proposed New York estate tax legislation is generally favorable to taxpayers in that it would increase the New York estate tax exemption, decrease New York estate tax rates and eliminate the New York generation-skipping transfer tax (discussed below). However, the proposed estate tax legislation is not all good news for taxpayers, particularly because it would virtually eliminate the ability to reduce the New York taxable estate by making lifetime gifts, giving only a narrow window of time in which to take advantage of a gifting strategy before the change goes into effect on April 1, 2014.

1. Inclusion of Lifetime Gifts in Gross Estate

For New York resident decedents, the proposed legislation would include in the gross estate the amount of taxable gifts made on or after April 1, 2014, if the decedent was a

New York resident at the time the gift was made. This means that, assuming the proposed legislation passes in its current form, New York residents will no longer be able to reduce their New York estate tax by giving assets to their children (or other intended heirs) during their lifetimes in excess of the annual exclusion (currently \$14,000 per donee). New York residents should still be able to reduce their taxable estates by making gifts that qualify for the annual exclusion or for the tuition and medical care exclusions.

Consequently, New York residents should consider making gifts no later than March 31, 2014. In considering whether to make gifts, note that gifts made to the extent of the available federal exemption would not be subject to gift tax. The federal exemption amount is currently \$5.34 million per individual (\$10.68 million for a married couple), less any exemption used during life. **Please contact us as soon as possible if you would like to discuss a gifting strategy or if you have any questions.**

2. Higher Exemptions and Lower Tax Rates

The New York estate tax exemption is currently fixed at \$1 million. For federal estate tax purposes, however, the estate tax exemption is \$5 million plus an amount to adjust for inflation since 2011. For decedents dying in 2014, the federal estate tax exemption is \$5.34 million.

The proposed New York legislation would increase the New York exemption amount to bring it up to the federal exemption level. It would do so over a period of several years.

However, the proposed legislation includes a provision that phases out the exemption for taxable estates that exceed

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the exemption amount. Under this provision, for taxable estates that exceed the exemption amount by more than 5%, the exemption amount is reduced to zero. There is significant opposition to this provision and it is unclear whether it will be in the final legislation.

Apart from the increased New York exemption amount, the maximum New York estate tax rate would decrease over several years, from its current rate of 16%, so that the maximum rate for decedents dying on or after April 1, 2017, would be 10%. Because the state tax is deductible against the 40% federal estate tax, the effective rate on the largest estates is 9.6% under current law and would be reduced to 6.0% under the proposed legislation.

The following chart, based on the proposed statute, summarizes the increase in exemption and decrease in tax rates:

For Decedents Dying:	Maximum NY Estate Tax Rate:	Incremental Tax on Largest New York Estates:	NY Estate Tax Exemption:
Prior to April 1, 2014	16.0%	9.6%	\$1,000,000
April 1, 2014 – March 31, 2015	14.5%	8.7%	\$2,062,500
April 1, 2015 – March 31, 2016	13.0%	7.8%	\$3,125,000
April 1, 2016 – March 31, 2017	11.5%	6.9%	\$4,187,500
April 1, 2017 – December 31, 2018	10.0%	6.0%	\$5,250,000
On or after January 1, 2019	10.0%	6.0%	\$5,250,000 plus a cost-of-living adjustment for years since 2012

3. Elimination of the New York Generation-Skipping Transfer Tax

Current New York law imposes a generation-skipping transfer tax (“GST tax”) on certain generation-skipping transfers from trusts that occur at the same time as, and as the result of, the death of an individual. The proposed legislation would repeal the New York GST tax.

Proposed Changes to Income Taxation of Certain Trusts, Grantors and Beneficiaries

1. “Incomplete Gift” Trusts Created by New York Residents to Be Treated as Grantor Trusts

Under the proposed legislation, trusts created by New York residents that were structured so as to cause transfers to the trusts to be “incomplete gifts” for federal gift tax purposes will now be deemed to be “grantor trusts” for New York income tax purposes. This means that, for New York income tax purposes, all the trust’s income and deductions are reportable on the grantor’s income tax return.

Note that even if the trust is a separate taxpayer for federal income tax purposes, it will be deemed to be owned by the grantor for New York income tax purposes. In addition, it appears that the new grantor trust treatment covers all “incomplete gift” trusts created by New York residents—those who are currently exempt from New York income tax (see section 2 below) and those who currently pay (their own) New York income tax.

An analogous rule will apply with respect to New York City income tax. Thus, trusts created by NYC residents that were structured so as to cause transfers to the trusts to be “incomplete gifts” for federal gift tax purposes will now be deemed to be grantor trusts for NYC income tax purposes.

Although these rules would be effective for taxable years beginning on and after January 1, 2014, they would not apply to income from a trust liquidated before June 1, 2014.

Accordingly, New York residents who have created an “incomplete gift” trust that is exempt from New York income tax and that is expected to have substantial 2014 income prior to June 1 should consider whether to liquidate the trust before June 1 in order to avoid grantor trust treatment (and consequent income taxation) with respect to 2014 income earned before June 1. Please contact us as soon as possible if you would like to discuss possible strategies or if you have any questions.

2. New York Resident Beneficiaries of Certain Trusts May Now Be Taxed on Accumulation Distributions

Under current law, trusts that are created by non-New York residents (known as “nonresident trusts”) generally are not subject to New York income tax (except on New York source income). Similarly, trusts that are created by New York residents but that have no trustees who are New York residents, no assets located in New York and no New York source income (known as “exempt resident

trusts”) generally are not subject to New York income tax. To the extent that these trusts accumulate their income for distribution to beneficiaries in later years, the income is not taxed to either the trusts or the beneficiaries, thus escaping New York income tax entirely.

If the proposed legislation passes in its current form, New York resident beneficiaries of nonresident trusts and exempt resident trusts will be subject to income tax on distributions of accumulated income that they receive. (This new rule does not apply to “incomplete gift” trusts created by New York residents. As discussed above, the income of these trusts will be taxed to the grantor.) However, under the most recent version of the proposed legislation, the beneficiary will not be taxed on certain income earned by the trust, including income earned before 2011 or in any year prior to when the beneficiary became a New York resident. The beneficiary will be entitled to a credit against his or her New York income tax for income tax imposed on the trust by another state in the current or any prior taxable year.

Nonresident trusts and exempt resident trusts that make an accumulation distribution to a New York resident beneficiary in any taxable year will be required to file an information return for that year to identify the resident beneficiary and the amount of the distribution.

Analogous rules will apply for NYC income tax purposes. Thus, NYC resident beneficiaries of non-NYC resident trusts and exempt NYC resident trusts will be subject to income tax on certain accumulation distributions they receive from such trusts.

Although the rules would be effective for taxable years beginning on and after January 1, 2014, they would not apply to trust income paid to a beneficiary before June 1, 2014.

Accordingly, trustees of trusts that have (or may in the future have) one or more New York resident beneficiaries and that either were created by non-New York residents or were created by New York residents but are exempt from New York income tax should consider whether to take action before June 1, 2014, in order to avoid potential future New York income tax to the beneficiaries on any accumulated income. Please contact us as soon as possible if you would like to discuss possible strategies or if you have any questions.

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