



New York Estate and Trust Tax Changes: the Good, the Bad and the Ugly

As we noted in our recent [client alert](#), New York Governor Andrew Cuomo announced in January that he would introduce legislation intended to reduce the estate tax incentive for New Yorkers to move out of the state shortly before death. The devil is in the details, though. While the new law, which the governor just signed, provides some tax relief for the moderately well-off, the wealthiest New Yorkers will see little, if any, change and, in some cases, will actually experience an increase in estate and income tax.

The major elements of the governor's original proposal would have both reduced the top New York estate tax bracket from 16 percent to 10 percent and gradually increased the exemption amount from the current \$1 million to match the federal exemption (currently \$5.34 million, inflation adjusted going forward), over the course of the next several years. The proposal also included a number of less-taxpayer-friendly provisions.

As part of the budget process, the proposal has been modified substantially. Here are the results:

Estate Tax

Top bracket: remains at 16 percent.

Exemption amount: phases in to match the federal exemption by 2019. Note that due to the "cliff" (described below), and unlike the federal exemption, estates that exceed these amounts by 5 percent do not benefit from the New York exemption at all, and even estates that exceed the exemption by a smaller percentage forfeit part of the exemption. The phase-in is as follows:

Date of Death	New York Exemption
April 1, 2014 – March 31, 2015	\$2,062,500
April 1, 2015 – March 31, 2016	\$3,125,000
April 1, 2016 – March 31, 2017	\$4,187,500
April 1, 2017 – December 31, 2018	\$5,250,000
On or after January 1, 2019	Same as the federal exemption

Gift Look-back:

The original proposal to include certain lifetime gifts in the taxable estate has been scaled back. The add-back is now only for taxable gifts made between April 1, 2014, and December 31, 2018, and within three years of death. This rule does not apply to annual exclusion gifts (currently \$14,000 per donee), payments of tuition or medical expenses that qualify for a federal gift tax exemption, or gifts made while the donor was not a New York resident.

The limited scope of the new estate tax on lifetime gifts certainly makes it less onerous than the original proposal, and it now coordinates better with the federal estate tax (which includes in the tax base any federal gift tax on gifts in excess of the federal exemption, when made within three years of death). Nevertheless, this remains a trap for the unwary, given that large lifetime gifts remain an important federal estate tax planning option in some circumstances. This new New York estate tax on lifetime gifts is especially expensive because of the interplay with the federal estate tax (see below for details).

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The add-back seems to apply even to gifts of real estate or tangible personal property outside of New York state. If this property is owned at death, however, it is not subject to New York estate tax under current law or even under the revised law, so giving it away would not reduce the taxable estate. Imposing the add-back on these gifts seems out of place – like trying to close a loophole that doesn't really exist. In fact, there are serious constitutional questions as to whether a non-New York gift can properly be included in the New York estate tax base at all. The New York Tax Department (or the courts) may construe this new tax narrowly, to avoid the constitutional issue, by excluding property outside the state, but until that happens donors should be aware of this risk.

Income Tax

New Tax on Distributions from Trusts:

Beginning immediately, a New York resident who receives a distribution of income from certain trusts may incur an additional income tax known as a “throwback” tax. Basically, the resident beneficiary may have to pay an additional tax as if the trust income had been subject to New York tax during the year the trust accumulated the income if the trust:

- (a) was created by a New York resident (which makes it a resident trust) but was not taxed in a given year as a resident trust because the trust satisfied the test that allows the trust to escape New York tax (during any year in which a resident trust has no New York resident trustee, no New York hard assets such as real estate or tangible property, and no income generated from New York hard assets or businesses, the trust is an “exempt” trust that will not be subject to New York income tax during that year), and
- (b) accumulates income during a year when it is an exempt trust, and then
- (c) distributes the accumulated income in a future year to a New York resident.

This provision will not apply to trusts that are not created by a New York resident or to income accumulated prior to January 1, 2014, both of which would have been subject to the tax under the original proposal. Nevertheless, this new tax imposes a serious record-keeping burden on exempt resident trusts and onerous reporting and computational issues for the beneficiary, and it may drive complex alternate arrangements to avoid the throwback tax.

ING Trusts:

Some New York taxpayers have adopted a strategy of creating “incomplete gift non-grantor trusts” (INGs) in other states, which are intended to avoid New York income tax on the income and gains from assets transferred to the trust without incurring a current gift tax. Going forward, New York will treat those trusts as if they were grantor trusts for New York purposes, meaning that the grantor who was trying to avoid the New York tax will be required to pick up all of the trust's income on his or her personal state (and city) income tax return. By contrast, for federal purposes the same trust will continue to be treated as an independent taxpayer, introducing a disparity between state and federal taxation of the same trust's income.

Old Problems Not Resolved

The Cliff:

Unfortunately, the New York tax law continues to phase out the benefit of the estate tax exemption rapidly as the estate gets larger, and completely once the taxable estate exceeds 105 percent of the exemption amount (an estate of that size is entitled to no exemption at all). For example, for the next year, an estate in excess of \$2,165,625 will be taxed on the entire estate, with no benefit from the exemption whatsoever. As the size of the state exemption increases over the next few years, the impact of the cliff grows along with it. By contrast, the federal estate tax applies only to the taxable estate in excess of the exemption, so that even the largest estates will not be taxed on the exempt amount for federal purposes.

No Portability of Exemption Between Spouses:

Under the current federal estate tax, the unused exemption of the first spouse to die may be carried forward and used by the second spouse (the concept of portability of exemption). While there was some interest – at least in the Assembly – in allowing New York portability, it became apparent that as long as New York has the exemption cliff, portability cannot possibly work in New York. As a result, New Yorkers cannot rely on portability to take advantage of the full New York exemptions in both estates of a married couple, but instead will require a credit shelter trust or other structure similar to what has been common for years.

No Separate New York QTIP Marital Election:

Because of the large difference between the federal and state exemption amounts, until the larger New York exemption is fully phased in, it may be advantageous in certain circumstances for an estate to treat certain trusts

as qualified terminable interest property, or QTIP, trusts eligible for the New York estate tax marital deduction, while the same trusts would be better treated as non-marital for federal purposes. The Senate version of the New York tax legislation would have authorized this separate election for estates smaller than the federal exemption amount, but that provision did not make the final bill. Guidance from the New York Tax Department suggests that a separate election is not available if a federal estate tax return is filed (as it must be to elect federal portability). Thus, the flexibility of estate tax planning remains incomplete for New Yorkers, and some estates will have difficult decisions to make.

Planning Tips

Consider deferring large gifts. Current New York residents who expect to remain in this state for the rest of their lives, and who have not already made larger gifts to take advantage of the federal exemption, should consider deferring major gifts until 2019, when the New York gift add-back expires, or using alternative approaches. Whether or not a gift will save overall taxes depends on many factors, including projected increase in value, cost basis for calculating capital gains upon a future sale (which may be higher in the case of a gift than if the asset is retained), anticipated longevity of the donor (with three years being a critical factor), and the interplay of the state and federal tax systems. In many instances a large gift still makes sense in terms of the overall tax savings – but these gifts now may be more expensive for New Yorkers who make the gift during the next five years, if they die within three years of the gift. New Yorkers can continue to make annual exclusion gifts and payments of qualified tuition and medical expenses without adverse consequences.

For those moving to or from New York. Individuals who are planning to move to New York may wish to engage in gift planning prior to becoming a resident of the state. In the opposite case, New York residents who are thinking of moving elsewhere should make sure to take all the steps necessary to have the move recognized for tax purposes. If in fact the move is successfully completed, New York will not impose a gift tax or an estate tax on lifetime gifts, even on gifts made while the decedent was a New York resident.

Pernicious impact of gift add-backs. If the New York estate tax does apply to lifetime gifts, the impact will be significantly worse than the usual tax bite. Unlike the New York estate tax in general, the estate tax on lifetime gifts would not be eligible for the deduction against the federal estate tax (currently worth 40 percent, given that federal estate tax rate). If an estate is at the top New York bracket,

the general 16 percent New York estate tax in effect only costs 9.6 percent. If the New York estate tax applies to a lifetime gift, however, the 16 percent tax impact remains unreduced by a federal deduction.

In addition, if the New York estate tax on lifetime gifts applies, it is imposed on the estate even though the estate no longer owns the asset that was given away, possibly years earlier. Therefore, wills and revocable trusts of New York residents must be drafted with careful attention to the allocation of estate taxes to ensure that if the tax is due, it will be paid out of the fund that makes the most sense in terms of availability and fairness.

Continued complexity. Finally, because of the disconnect between the New York and federal exemptions, until the larger federal exempt amount is fully phased in for the New York estate tax in 2019, married clients must continue to consider whether to (a) carve out the entire federal exemption amount to a credit shelter or bypass trust at the first spouse's death and pay the resulting New York estate tax on the portion of the federal exemption amount that exceeds the New York exemption, or (b) limit the amount passing to these trusts to the lower state exemption amount (leaving unused a portion of the federal exemption, unless the circumstances permit federal portability rules to apply). The option of creating a separate trust for the difference between the state and federal exemptions and having it qualify for the state marital deduction while absorbing federal credit seems to be off the table, based on the position of the New York Tax Department.

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