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Recent Federal Tax Legislation May Have Unintended Consequence For State-Level Estate Tax

As we pointed out in our December 2017 Alert, the recently enacted federal tax legislation (the “Act”), which became effective January 1, 2018, may have a significant impact on existing estate plans, requiring clients to review their current documents to determine the impact of the Act. This Alert addresses the potential major impact of the Act on state estate taxes.

Clients residing in a state that imposes a state-level estate tax (such as New York or Connecticut)¹ may have an estate plan that includes a bequest of the entire federal exemption amount in a “bypass” disposition that is not intended to qualify for the estate tax marital or charitable deduction, even if a portion of the federal bypass amount will be subject to the state estate tax. In such a case, the large disparity which now exists between the federal and state exemption amounts could generate high levels of state tax, and, therefore, the clients should consider whether a change should be made to this estate plan. In the case of a married couple, this extra estate tax could be incurred at the death of the first spouse.

For example, the estate plan of some married couples provides that upon the death of the first spouse to die, the decedent’s remaining federal exemption amount is to be distributed to a trust for the benefit of the surviving spouse and children, with the balance of the estate passing to or for the benefit of the surviving spouse in a way that qualifies for the marital deduction (e.g., either outright or through a trust). Another example is where the estate plan of a married couple provides that upon the death of the first spouse to die,

the decedent’s remaining federal exemption amount is to be distributed to the children (either outright or in trust), with the balance of the estate passing in a way that qualifies for the marital deduction. In both cases, there should be no federal estate tax at the first spouse’s death. However, the estate of a decedent whose will or revocable trust includes such a bequest may now be subject to a state-level estate tax, where such tax would not have been imposed, or would have been much smaller, prior to the Act.

New York, which currently has an exemption amount of \$5.25 million for its own estate tax, was phasing in parity with the federal exemption as it existed prior to the Act. However, New York will not be in parity with the new doubled federal exemption. The result is that a bequest to a trust based on the federal exemption amount will incur a substantial New York estate tax (about \$1.26 million for a bypass bequest funded with the full federal exemption amount of almost \$11.2 million).

By contrast, Connecticut, which currently has an exemption amount of \$2.6 million, will phase in parity with the federal exemption effective January 1, 2020. Estates of Connecticut residents who die before then with a federal bypass bequest could face a Connecticut tax of up to \$864,600 (although in some cases it may be possible to structure a federal bypass bequest that would not be subject to Connecticut estate tax, a solution not available for New York residents).

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The large state tax can be avoided if the bypass disposition is limited to the lesser of the federal and state exemption amounts rather than just the federal exemption amount. Nevertheless, there may be circumstances in which measuring the bequest with the larger federal exemption and thereby incurring a state estate tax is desirable. This may be the case, for example, if it is expected that the assets in the bypass trust will generate a substantial amount of income and appreciation prior to the death of the surviving spouse, which would not be subject to federal or state estate tax at the death of the survivor. That would be desirable if the expected savings of both federal and state tax at the second death outweighs the extra state tax paid at the first death. There may be other considerations as well, including the prospect of future changes in either or both the federal and state estate tax. It also may be possible for New York residents to avoid a large state estate tax by making gifts that reduce the amount of the unused federal exemption to less than the New York exemption.

If you think your estate plan may be impacted by the Act and would like us to review your estate planning documents, please contact us promptly so that we can assess your situation and determine what changes, if any, may be appropriate.

If you have any questions, please don't hesitate to contact us.

¹ *New Jersey has repealed its estate tax (but not its inheritance tax) effective January 1, 2018.*

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