2014 CHANGES TO NEW YORK'S ESTATE, GIFT, AND TRUST INCOME TAXES

(REVISED)

Effective April 1, 2014, the 2014-2015 budget legislation (the "Executive Budget") makes significant changes to New York's estate tax and the income taxation of certain trusts. These changes will have a major effect on estate planning for both New York residents and non-residents. These changes provide some tax relief for the moderately wealthy. As for wealthier New Yorkers, however, they will see little, if any, change, except under certain circumstances that will cause an increase in estate and income tax. *See* "Gifts" and "ING Trusts" below.

Estate Tax Exclusion Increased – but only for Some. The Executive Budget increases New York's basic exclusion amount ($1 million per decedent prior to April 1, 2014) to $2.0625 million per decedent as of April 1, 2014, with gradual increases annually until January 1, 2019 when the basic exclusion amount will reach $5.25 million. Thereafter, it will be indexed for inflation, which should link New York's basic exclusion amount to the federal amount (presently $5.34 million, but also indexed for inflation). The basic exclusion amount is increased as follows:

Death on or After:	and Before:	Basic Exclusion Amount:
April 1, 2014	April 1, 2015	$2,062,500
April 1, 2015	April 1, 2016	$3,125,000
April 1, 2016	April 1, 2017	$4,187,500
April 1, 2017	January 1, 2019	$5,250,000

Read on, however, because what appears to benefit New Yorkers does not really favor the very wealthy under what is referred to as the "cliff." Because of this quirk in the way New York calculates its estate tax, the basic exclusion amount is *rapidly phased out* once the value of a decedent's taxable estate exceeds the basic exclusion amount in the year of death, *and is totally phased out* (e.g., is not available) when the value of a decedent's taxable estate is greater than 105% of the basic exclusion amount.

The Executive Budget implements the exclusion by allowing a credit of the "Applicable Credit Amount" to be taken against the tax imposed by the statute, as follows:

- If the New York taxable estate is less than or equal to the basic exclusion amount, the Applicable Credit Amount will be the amount of the tax so computed and, therefore, serves as a wash.

- If the New York taxable estate is up to 5% greater than the basic exclusion amount, the Applicable Credit Amount will be limited based on a formula, resulting in a rapidly increasing tax for each percent over the basic exclusion amount.

- If the New York taxable estate is greater than 105% of the basic exclusion amount, *no credit* is allowed.

By way of example, suppose D dies on April 20, 2014 with a New York taxable estate of $2,062,500. Because $2,062,500 is the basic exclusion amount at the time of death, there will be no estate tax due. If, however, D's taxable estate is $2,165,625 (i.e., 105 % of the basic exclusion amount), D's estate would pay a New York State estate tax of $112,050, determined as follows:

Basic Exclusion Amount ("BEA")		$2,062,500						
		5%						
		$103,125						
		$2,165,625						
Applicable Credit Amount ("ACA") = Tax on		$2,062,500	x	(1	-	$2,165,625 - $2,062,500		)
						$103,125		
		$2,062,500	x	(1	-	$103,125	)	
						$103,125		
		$2,062,500	x			$0	=	$0
ACA			=			Tax on		$0
Computation of Tax on	$0		@			3.06%	=	$0.00
Computation of Tax on		$2,165,625						
Excess over		$2,100,000	=			$106,800.00		
Tax on excess @	8.0%	$65,625	=			$5,250.00		
Tax before ACA						$112,050.00		
Less ACA			=			$0.00		
Tax on first	$103,125	above BEA	=			$112,050.00	[1]	

[1] That is, a $103,125 increase in D's taxable estate will result in an estate tax increase of $112,050 (or a marginal tax rate of 108.65%).

A similar computation would apply if the taxable estate is less that 105% of the basic exclusion amount. Each percent above the basic exclusion amount (up to 4%) would reduce the applicable credit amount by an additional 20%, thereby rapidly phasing out the applicable credit amount, which, in turn, increases the tax due for such estates.

For example, if D's taxable estate is $2,124,375, which is 3% greater than the basic exclusion amount ($2,062,500 x 3% = $2,124,375), D's estate tax would be $77,200, computed as follows:

Basic Exclusion Amount (BEA)		$2,062,500						
		3%						
		$61,875						
		$2,124,375						
Applicable Credit Amount (ACA)		$2,062,500	x	(1	-	$2,124,375 - $2,062,500	)	
						$103,125		
		$2,062,500	x	(1	-	$61,875	)	
						$103,125		
		$2,062,500	x	(1	-	0.6	)=	40.00%
ACA			=			Tax on		$825,000
Computation of Tax on		$825,000						
Excess over		$500,000	=			$15,300		
Tax on excess	5.0%	$325,000	=			$16,250	=	$31,550.00
Computation of Tax on		$2,124,375						
Excess over		$2,100,000				$106,800.00		
Tax on excess @	8.0%	$24,375				$1,950.00		
Tax before ACA						$108,750.00		
Less ACA			=			$31,550.00		
Tax on first	$61,875	above BEA	=			$77,200.00 [2]		

[2] The result here shows that an increase of only $61,875 in D's taxable estate will result in an estate tax increase of $77,200.00 (or a marginal tax rate of 124.77%).

Now, suppose D's taxable estate is significantly greater than the basic exclusion amount, say $6,200,000, and ***no credit*** is allowed. This would bring the tax calculation into a higher tax bracket (i.e., 12.8%), and D's estate would pay a New York State estate tax of $535,600 (tax on $6.1 million = $522,800 plus $12,800 (12.8% on the excess of $100,000)). That is, taxable assets of slightly more than 200% of the basic exclusion amount (i.e., $2,062,000 x 200.6% = $4,137,375) will cause D's estate to pay a New York estate tax of $535,600.

Estate Tax Bracket. The Governor's budget bill originally included a reduction of the estate tax bracket from 16% to 10%. The Executive Budget, however, keeps the top bracket at 16%. Interestingly, the rates included in the Executive Budget only cover the period for a decedent dying on or after April 1, 2014 and before April 1, 2015. While this might have been an error that will require a technical correction, there is some question as to whether it is a time-limited compromise, test period or mandate reached during the budget negotiations.

Note that although the top bracket is still 16%, there has been a change in bracket structure. As a result, estates valued in excess of 105% of the basic exclusion amount will have the same tax they would have had under the old law.

Gifts. New York has not had a gift tax since 2000 when New York's gift tax was repealed. Consequently, a commonly used estate planning technique to reduce the size of a New York resident's estate tax was to make gifts within the allowable federal exemption. Not only was the donor able to make a completed gift without incurring gift tax liability in New York, but so long as she had not retained an interest in the gifted property, she was assured that the value of the gift would not come back into her estate for estate tax purposes. The Governor's budget bill proposed to close this loophole by including in one's New York taxable estate certain gifts made after April 1, 2014. The legislature, however, pared back the extent to which lifetime gifts must be added back by limiting this add back to taxable gifts made within three (3) years of death (if not otherwise includible in the federal gross estate), exclusive of gifts made (i) when the decedent was not a resident of New York, (ii) before April 1, 2014, and (iii) after December 31, 2018. (In general, "taxable gifts" do not include annual exclusion gifts (currently $14,000 per donee) and payments made *directly* for tuition and medical expenses.) The add back, however, does not appear to exclude gifts of real or tangible personal property *outside* of New York State, which, if owned at a decedent's death, would not be subject to New York's estate tax.

Although the add back provision under the new law is not nearly as onerous as originally proposed, gifts that are added back are not likely to be eligible for the state death tax deduction against the federal estate tax. This is because this deduction, as allowed under section 2058 of the Internal Revenue Code, must be paid "in respect of any property included in the [federal] gross estate . . . ." Since gifts added back under the new law would *not* be a part of the federal gross estate, they would not likely be eligible for the state estate tax deduction for federal estate tax purposes.

The top estate tax rate on property included in decedent's federal and New York gross estate is 40% federal plus 16% New York. However, since estate taxes paid to New York on property includible in the decedent's federal gross estate are deductible in computing the federal estate tax, the top effective New York rate is 9.6% (i.e., 16% – [16% x 40%] = 9.6%). Hence, gifts added back to the decedent's estate under the new law will be subject to an additional tax of 6.4% as compared to

having the same property included in the decedent's gross estate.

Furthermore, because the New York estate tax will be imposed on gifts that are no longer held in the estate, when drafting Wills and revocable trust agreements it will be important for attorneys to consider and specify the estate assets that would be the best source against which to allocate the New York estate tax due on such gifted assets.

Throwback Tax on Distributions of Accumulated Income. Under the Executive Budget, New York resident beneficiaries may be subject to a "throwback tax" on certain distributions they receive from "New York Resident Trusts" (except an incomplete gift non-grantor or "ING" Trust - see below) as if the income earned in the Trust had been subject to New York income tax during the year the income was accumulated. A New York Resident Trust is one created by a New York resident (ergo, a "Resident Trust") but, under the prior law, was not taxed during a given year where (i) none of the trustees were domiciled in New York during that year, (ii) no real or tangible trust property was located in New York, *and* (iii) neither trust income nor gains were derived from New York sources, thereby allowing the trust to be exempt from New York income tax during that year. The throwback tax will apply if the trust (a) falls within the meaning of a New York Resident Trust, (b) accumulates income during a year in which it qualified as an "exempt trust," and (c) accumulated income is distributed in a later year to a beneficiary who is then a New York resident. The throwback tax will not apply to income of a non-resident trust or an exempt resident trust (i) paid to a beneficiary before June 1, 2014 or (ii) earned by such trusts in a taxable year (aa) before the beneficiary first became a New York resident or (bb) in any taxable year beginning before January 1, 2014

The original throwback rules would have also taxed income accumulated before January 1, 2014 and trusts created by non-New York residents. Even as improved, though, the throwback tax provisions will cause burdens of record keeping not only to trustees but also to tax preparers.

ING Trusts. An ING Trust, referred to above, is an incomplete gift non-grantor trust created by a New York taxpayer in another state to avoid New York income tax on the income and gains from the assets transferred to the trust without current gift tax liability. Under the Executive Budget, effective immediately for tax years beginning on or after January 1, 2014, but excluding income earned by ING Trusts that are liquidated before June 1, 2014, an ING Trust created by a New York taxpayer will be treated as a grantor trust for New York purposes. As a result, the New York taxpayer who had been trying to avoid the New York tax will now be required to pick up all of the trust's income on her income tax return. This, in turn, will cause a disconnect between the New York state and federal reporting with the same trust, for federal tax purposes, continuing to report the income as derived from a non-grantor Trust.

Valuation. Valuation of an estate as of date of death or the alternate valuation date for New York estate tax purposes must be the same as for federal estate tax purposes. If a federal return is filed, New York must use the same values and valuation date as shown on the federal estate tax return. If no federal return is filed, the New York return must reflect the same methodology as would have been used had a federal return been filed (e.g., no election to use alternate valuation may be made unless it will decrease the value of New York's gross estate as well as the amount of tax).

Repeal of New York's GST Tax. The Executive Budget has repealed New York's generation-skipping transfer ("GST") tax, applicable to taxable distributions to "skip persons" and taxable terminations where "skip persons" receive a trust distribution on its termination.

QTIP Election. Although the Senate version of the budget bill included a provision specifically allowing for a separate New York qualified terminable interest property ("QTIP") election to be made where a federal estate tax return was required for purposes of electing portability, that provision did not make it to the final version of the Executive Budget. As a result, a New York QTIP election will not be allowed where (i) a federal estate tax return is required to be filed *and* (ii) a QTIP election is not made on that return. A New York QTIP election will, however, be allowed where no federal estate tax return is required to be filed.

Portability. Although the Assembly had expressed an interest in a provision for the unused New York exemption of the first spouse to die to be "ported" to the surviving spouse who could then use the first spouse's remaining exemption, and such a provision had been drafted and submitted to the Legislature, it was not included in the Executive Budget, most likely because of the difficulty in seeing it carried through in light of New York's exemption cliff. This creates further issues for a New Yorker planning his or her estate. As a result, (i) New Yorkers should continue to use credit shelter trusts as part of their estate planning since they will not be able to rely on portability to take advantage of an otherwise wasted exemption; and (ii) New Yorkers who expect that their estate will not exceed the then applicable federal exemption will need to weigh the benefits of (aa) electing portability for federal estate tax purposes or (bb) not filing a federal estate tax return in order to make a New York QTIP election. In making the decisions in "(i)" and "(ii)" above, consideration should also be given to the income tax rates vs. the estate tax rates and (particularly in the case of a first marriage) the benefits of outright dispositions to take advantage of income tax savings with portability, which could be costly in New York where there is no provision for portability.

Conclusion. As a result of the passage of the Executive Budget, estate planning for New Yorkers must still look to old tools, such as the credit shelter trust to achieve estate planning goals. In addition, gift planning must be carefully considered. Unless section 2058 of the Internal Revenue Code (the state death tax deduction) will be determined to include gifts added back under the new law (which is not likely), careful consideration will have to be given to the loss of the full deduction in determining the benefits of making large gifts (e.g., getting the income and appreciation on the gifted assets out of one's estate). The timing of making gifts must also be considered if one is moving into or out of New York. Due to the cliff and New York's keeping its top estate tax bracket at 16%, the wealthiest New Yorkers will be still incentivized to move out of the state to take advantage of more tax-favored jurisdictions.