THE NEW YORK STATE ESTATE TAX ON ESTATES OF NON-RESIDENT DECEDENTS -- EVOLVING FROM ONFISCATORY AND UNCONSTITUTIONAL TO ALMOST REASONABLE AND RATIONAL

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I. NEW YORK STATE ADOPTS (AND QUICKLY ABANDONS) THE "SOP TAX"

1. **New York Joins the Crowd** --

In 1997, after years of taxing estates at rates ranging from 2% to as high as 21%, New York adopted a so-called "SOP Tax" system, in part to stem the flow of retired New Yorkers to states such as Florida where more favorable temperatures and tax systems could be found. The 1997 legislation provided that, commencing with decedents dying on or after February 1, 2000, New York would impose estate taxes no higher than the amount available as a credit against a decedent's federal estate tax, thus reducing its maximum estate tax rate to 16% and eliminating taxes entirely on smaller estates.

2. **New York "Walks" after a Federal "Double Cross"** --

When the federal government decided in 2001 to exempt increasingly larger estates from federal estate taxation, but to reduce the credit it would allow against the federal estate tax for estate taxes paid to the states, New York, by then facing a new budget crunch, decided that it had gone far enough in reducing its estate tax and refused to exempt estates larger than one million dollars from the tax. It also decided to assess estates of its resident decedents with taxable assets in excess of $1 million with the full amount which had previously been allowed as a credit by the federal government for state death taxes paid by those estates. This "decoupling" began to take effect with the estates of decedents dying on or after January 1, 2002.

II. NEW YORK AND THE NON-RESIDENT DECEDENT

1. **<u>You Don't Have to Be a New Yorker to Pay Taxes</u>** --

Under the 1997 New York legislation, the tax on non-resident decedents' estates was also to be determined with reference to the available state death tax credit. Here, however, since the tax was to be assessed only with respect to real and tangible personal property having a situs in the State of New York, the tax would presumptively be equal to the pro rata share of the non-resident decedent's total gross estate that was represented by the decedent's New York realty and tangible personalty.

2. **<u>Tax Simplification, New York Style</u>** --

To accomplish this, Section 960 of the New York Tax Law took a rather roundabout approach to calculating the tax on the estate of a non-resident decedent. It provided that the tax would be the same as the tax assessed on a resident decedent's estate (determined under Section 952 of the Tax Law by subtracting the portion of the available estate death tax credit attributable to non-New York realty and tangible personalty from the total available credit), except that the decedent's intangible personalty would in effect be treated as non-New York realty or tangible personalty in making this calculation. Then, for some reason, an alternate method of determining the New York estate tax was incorporated into Section 952 (and, by reference, into Section 960). The alternate method was to subtract from the maximum allowable state death tax credit only so much of the credit as was owed to another state by the decedent's estate.

3. **<u>The "Stealth" Provision</u>** --

In providing these alternate methods of calculating the New York estate tax, Section 952 provided that the tax would be equal to the <u>greater</u> of the two alternatives. Therefore, <u>New York would collect at least its proportionate share of the available state death tax credit from its resident decedents, and, if another state did not collect its proportionate share of the credit, New York would take that as well.</u> The constitutional basis for, in effect, assessing taxes on property over which New York had no jurisdiction was questionable, but as a practical matter (at least judging by the lack of publicity about such problems)[1], there seem to have been few problems generated by the language of Section 952 with respect to the estates of resident decedents, presumably because the Internal Revenue Service was not questioning what appeared to be unremarkable claims to state death tax credits on the federal estate tax returns filed by these estates.

III. BUT WHAT'S THIS? GROTESQUELY EXCESSIVE ASSESSMENTS OF TAX ON NON-RESIDENT ESTATES PUZZLE THE PROFESSION

1. **If You're Not Using that Credit, We'll Take It.** --

In 2003, after the new provisions had been in effect for a while, a curious situation began to develop in some non-resident estates. Articles started showing up in various publications, commenting on what appeared to be an emerging nightmare for the estates of non-residents. These estates were finding themselves in situations where the Department of Taxation and Finance was demanding New York estate taxes that in some cases exceeded the value of the New York assets but where the eligibility of these taxes for the state death tax credit on the estate's federal return was at best questionable. Some of these articles suggested planning strategies for non-resident clients with New York assets. One suggested litigation tactics for estates of decedents already facing such assessments. Another pointed to a line of United States Supreme Court decisions indicating that New York's new method of assessing tax on non-resident estates was unconstitutional, and predicted that the Department of Taxation and Finance would eventually surrender to estates challenging these assessments:

(a) In an article entitled "The Application of the New York Estate Tax to Non-residents of New York State", by Lee A. Snow, that appeared in the Summer 2003 issue of the New York State Bar Association's Trusts and Estates Law Section Newsletter, an example was given of an estate of an Arizona resident in which the New York State estate tax would equal 31% of the value of the decedent's New York assets – - a percentage far in excess of the maximum state death tax credit (16%). A second example in the same article suggested that a New York tax of 150% of the value of the New York assets would be possible in such an estate. The author mentioned that in discussions with estate tax attorneys in Albany, he was advised that the Department of Taxation and Finance felt bound to a literal application of the language of Section 960 of the Tax Law (i.e., we'll take it [the credit] if no one else does), notwithstanding the apparently unfair (or perhaps unconstitutional) assessments it could generate.

(b) In another article in the Fall 2003 issue of the same publication, Jocelyn D. Margolin noted that the situation would get worse after 2001, when the Federal government would stop allowing a full state death tax credit but New York would still collect tax equal to the credit even if other states did not. She suggested various methods for non-residents to turn their New York realty and tangible personalty into an intangible asset not subject to New York tax (e.g., transfer to an LLC), or even getting rid of the property altogether, but these of course worked only if the decedent had not already become a decedent.

(c) Finally, in the Winter 2003 issue of the same publication, in an article entitled "The New York Non-Resident Estate Tax: A Tax That Can Be Less Than It Seems To Be", Mal L. Barasch and Kata B. Schissler wrote of a "recent unreported case" in which State Tax had attempted to assess over $400,000 in New York estate taxes on approximately $50,000 of New York property, but later relented and assessed a tax of about $3,000 against the non-resident estate. The Barasch/Schissler article analyzed the situation that led to the reversal of the State's position, describing several United States Supreme Court holdings that a state has no power to tax the transfer of a non-resident decedent's property over which it has no jurisdiction. These decisions also prohibited states from assessing indirectly taxes that they are constitutionally prohibited from assessing directly. The article also mentioned Revenue Ruling 56-230 (1956-1 CB 660) in which the Internal Revenue Service determined that any estate taxes assessed by a state in violation of these constitutional prohibitions would not qualify for the State death tax credit in determining the estate's federal estate tax liability.

2. **<u>What do New York, Alabama and Mississippi Have in Common?</u>** --

In the meantime, the New York State situation began to attract national attention:

(a) In the Summer 2003 issue of "ACTEC Notes" (The quarterly publication of the American College of Trust and Estate Counsel), in referring to "an almost comical situation" developing in Alabama and Mississippi, whose current statutes would take a decedent's entire estate for the state's estate tax if their laws were not changed by 2005, the authors of an article on the phase out of the state death tax credit under EGGTRA mentioned that "other states, such as New York, could impose a tax larger than the value of property in New York on non-residents because of the formulas used to apportion tax between the state of residence and New York."[2]

(b) Course materials for a nationwide American Bankers Association teleconference presented by the Illinois office of Schiff Haradin LLP on February 5, 2004 on the ramifications of the state death tax credit phaseout also made reference to the problem, but indicated that the New York State Department of Taxation and Finance had decided to relent and limit its assessments on non-residents' estates to the proportionate share of the state death tax credit attributable to the New York realty and tangible personalty (see p.5 of the course materials). However, the source of this information later proved to be unreliable.

3. **<u>State Tax Passes the Buck</u>** --

Although such a change of position was clearly contemplated, and perhaps tentatively decided upon in the Department of Taxation and Finance, the staff members eventually decided that it was up to the legislature, and not to them, to make such a decision.

IV. EXPATRIATES BEWARE!

1. **The Department of Taxation and Finance Finds its "Dream" Non-Resident Estate** --

In the estates of U.S. citizens domiciled abroad, it is often the case that little or no estate tax is imposed by any of the 50 States, thus leading to the possibility that New York would interpret its statute to permit it to assess taxes equal to all or virtually all of the available state death tax credit should it find any realty or tangible personalty owned by the decedent within its borders.

2. **Closing the Budget Deficit in One Easy Lesson** --

In one case, New York assessed $93,468.97 in New York estate tax on $855.00 of New York tangible personalty owned by a decedent domiciled in China at the time of his death, an effective tax rate of 10,932%! This assessment was protested, and the protest was "under review" in Albany for over two years.

V. THE GOVERNOR STEPS IN

1. **Good News and Bad News** --

In his 2004 Budget Bill, Governor Pataki proposed an amendment to Sections 952 and 960 of the Tax Law[3] that would solve the problem by eliminating the language of Section 952 that allowed New York to collect any portion of the available State death tax credit that was not being claimed by another state. Unfortunately, perhaps as a result of confusion caused by the decoupling of New York State's estate tax system and the federal system after 2001 due to the passage of EGGTRA, the governor's bill would apply only to estates of decedents dying on or after January 1, 2002, thus leaving the estates of decedent's dying between February 1, 2000 (the initial effective date of New York's SOP Tax) and December 31, 2001 "out in the cold".

2. **Senator Hannon to the Rescue --**

Long Island's Senator Kemp Hannon, having learned of the effective date problem, then introduced his own Bill (Senate 7048) on April 19, 2004. This Bill provided for the same modifications to Sections 952 and 960 as the Governor's Bill, but made them effective with respect to the estates of decedents dying on and after February 1, 2000, thus providing relief to all affected estates.

VI. RESOLUTION (OF SORTS)

On August 20, 2004, Governor Pataki signed into law the Budget Bill containing amendments to Sections 952 and 960 of the Tax Law. These changes, which were contained in Part I, Sections 3, 4 and 5 of Chapter 60 of laws of 2004, corrected the problem, but only for the estates of decedents dying on or after January 1, 2002. The estates of both resident and non-resident decedents who died between February 1, 2000 and December 31, 2001 were still potentially subject to unconstitutional estate taxation of property over which New York State had no jurisdiction.

The failure of the legislature to pass the Hannon bill, which would have corrected the problem for all affected estates, was apparently due to the concern of the Department of Taxation and Finance that it would have to make significant refunds to the estates of decedents who had died within that 23-month period. However, if the estate tax proceedings remained open in those estates, the Department indicated that it would treat the estates as if they were covered by the new legislation, and withdraw its claims for taxes assessed under the old versions of Sections 952 and 960.[4]

The logic behind the refusal of the state to change its position with respect to the February 1, 2000 through December 31, 2001 estates whose tax proceedings were already closed was that tax payments by those estates had presumably been fully allowed as a credit against the estates' federal estate tax liability, the federal phaseout of the State Death Tax Credit not having commenced until January 1, 2002. Although this logic seems to be the equivalent of "Why change something we've already gotten away with?", it might be more gently described as a simple "No harm, no foul" determination, or, perhaps more appropriately, "We need the money more than Washington does."

VII. TRANSFORMING TAXABLE ASSETS INTO NONTAXABLE PROPERTY

1. **The Intangible or Tangible Mystery – Now You See It, Now You Don't** –

Once the tax department conceded that it was inappropriate to tax assets not subject to its jurisdiction, its focus, and that of taxpayers, shifted to what was in fact subject to it.

A non-resident decedent is liable for New York estate tax only if the decedent owned New York real estate or tangible personal property located in New York. No New York estate tax is imposed on intangible assets held by a non-resident decedent.[5] Whether a non-resident decedent's interest in an entity holding real estate, such as a trust, limited liability company, partnership or corporation, will be considered an intangible, and thus excludable from the decedent's New York gross estate, depends upon whether the entity is treated for income tax purposes as an entity separate from the taxpayer. Another factor given great weight by the Tax Department is whether the entity has a business purpose.

The Department of New York State Taxation and Finance has published several Advisory Opinions providing guidance on the estate tax treatment of New York real estate held by an entity owned in whole or in part by a non-resident decedent. Although these Advisory Opinions are binding only with respect to the taxpayers to whom they are issued, the reasoning gives an indication of how similar situations might be treated and provides a road map for future estate tax planning. These Opinions, which are reviewed below, can be found on the New York State Department of Taxation and Finance website.[6]

2. **Ownership by a Trust** --

Transferring title of New York realty to a revocable trust will not be sufficient to avoid New York estate tax on a non-domiciliary decedent's estate, since a revocable trust is not treated as an entity separate from the taxpayer for income tax purposes. For the trust's interest in the realty to be treated for estate tax purposes as an intangible asset, the revocable trust must hold the real estate in an entity which is treated for income tax purposes as an entity separate from the taxpayer. For example, the Tax Department treated as an intangible asset a revocable trust created by a non-resident decedent which held a membership interest in a multi-member LLC, that was taxed for income tax purposes as a partnership.[7] Title to the New York real estate was held in the name of the LLC. Similarly, a revocable trust created by a non-resident decedent funded with a 50% interest in a partnership that owned several cooperative apartments in New York was treated by the New York State Tax Department as intangible property and therefore not subject to New York estate tax.[8]

In the case of a non-domiciliary who had created a qualified personal residence trust (QPRT) funded with New York real estate, and who had failed to survive the term, resulting in inclusion of the New York realty in her gross estate, the Tax Department advised that the realty would be subject to New York estate tax, on the grounds that the real estate transfer to the trust was not complete until the grantor's death, due to the grantor's retained interest in the trust. The Tax Department noted that if the trust had held intangible property instead of real estate the result would have been different, since intangible assets held by a non-domiciliary are not taxed in New York.[9]

In the reverse situation, where a New York domiciliary had created a revocable trust that was funded with out of state realty, the Tax Department did not consider the interest in the trust to be an intangible asset, but rather treated the trust as real property and subtracted the value of the real estate from the New York gross estate.

In this same opinion, the Tax Department also considered two other possible scenarios concerning resident decedents with irrevocable trusts funded with out of state real estate. One involved a resident decedent who had retained a general power of appointment over an irrevocable trust he had created which was invested in out of state real estate. In the other, an irrevocable trust created by a third party over which the resident decedent held a general power of appointment had invested in out of state real property. In both cases, the Tax Department determined that the trust realty should be treated as out of state real property not subject to New York estate tax and not treated as intangible assets.[10]

3. **Ownership by Single-Member LLC or S Corporation** --

Transferring title to real estate into the name of a single-member LLC which is 100% owned by a non-resident of New York will not be sufficient to avoid New York estate tax, since a single-member LLC is taxed as a disregarded entity for income tax purposes, unless an election is made to have the LLC taxed as an association and therefore treated as a corporation.[11] A non-domiciliary could avoid New York estate tax by having New York real estate held by a multi-member LLC, a partnership or by a corporation, provided that the entity has a business purpose and is not disregarded for tax purposes.[12] Of course, the non-resident would have to be comfortable with giving up part of his or her ownership, such as by gifting some of the interest to a family member, in order to avoid holding the entire ownership interest.

VIII. EVOLVING FURTHER INTO FAIRNESS FOR NON-RESIDENTS

1. **All Is Forgiven: New York Reconnects** –

The dawning of 2014 was a watershed moment in the world of New York estate tax because it ushered in drastic revisions to the New York estate tax law, many changes benefiting both residents and non-residents. Among the most significant amendments passed by Chapter 59 of the Laws of 2014 was the increase in the amount that could pass tax free at death – the basic exclusion amount.

The New York exclusion amount had been frozen at $1 million for over twelve years, since 2002, while the federal exclusion amount was gradually increasing. The new legislation adopted a gradual phase-in of increases to the New York estate tax exclusion amount beginning on April 1, 2014, so that by the year 2019 the New York exclusion amount will equal the federal exclusion amount. Both resident and non-resident estates became entitled to a basic exclusion amount of $2,062,500 for dates of death on and after April 1, 2014; increasing to $3,125,000 on April 1, 2015, $4,187,500 on April 1, 2016 and $5,250,000 on April 1, 2017. After January 1, 2019, the basic exclusion amount for New York estate tax will be equal to the federal basic exclusion amount and will be indexed for inflation in the same manner as the federal amount. Although climbing up these steps was something of a slippery slope, given the "cliff" awaiting those who stepped over the edges on the way up, all would be well for those who made it to the top in 2019. More about that later. A summary of all the amendments made to the New York estate tax effective April 1, 2014 are set forth in a concise manner in a New York State Department of Taxation and Finance Technical Memorandum.[13]

2. **<u>Something for Everyone: Major Reform in Calculation of the Estate Tax on Non-Resident Estates</u>** –

Chapter 59 of the Laws of 2014 also amended the definition of the New York gross estate and the New York taxable estate for both resident and non-resident estates, and revised the method of calculating the estate tax on a non-resident estate. This ended a long-standing inequity in the taxation of non-residents. Under prior law, the New York estate tax on a non-resident estate was calculated as follows: The New York estate tax was first computed on the entire gross estate, including assets outside of New York. Then this tax was multiplied by a fraction, the numerator equal to the assets not taxable by New York and the denominator being the entire gross estate, and the result was then subtracted from the estate tax on the entire gross estate. The difference was the estate tax owed by the non-resident estate.

This calculation resulted in the non-resident estate picking up the fraction of what would have been a New York resident's estate tax attributable to the New York assets. At first glance, this appears fair. However, when applied, it often resulted in an inequitable result by taxing a non-resident estate whose New York assets were valued at less than one million dollars.

For example, assume that the exclusion is $1 million, the New York assets are $500,000, the gross estate is $4 million and this is a non-resident decedent. Under the law in effect before April 1, 2014, this non-resident estate would have had to pay a New York estate tax of $35,050, even though the New York assets were only $500,000, well under the $1 million exclusion amount.

Under the new law, the non-resident's estate tax is no longer calculated by applying a fraction to the New York estate tax on the entire gross estate. Instead, the New York estate tax of a non-resident decedent is computed on the New York assets only and then the full exclusion is applied to that tax. In the above example, this would result in a zero New York estate tax on the non-resident estate.

3. **<u>But Let's Be Fair: If You Didn't Spend It Here</u>** –

In 2015, Section 960(b) of the Tax Law was amended to clarify that the computation of a New York taxable estate will not include any deduction allowable under the Internal Revenue Code related to any intangible personal property or non-New York realty or tangibles not includible in the New York gross estate of a non-resident. This amendment applies to estates of non-resident individuals with dates of death on or after April 1, 2014. The New York State Department of Taxation and Finance issued a Technical Services Bulletin regarding the application of this rule.[14]

Under these rules, to calculate the New York estate tax of a non-resident, deductions that relate directly to real and tangible property outside of New York are disallowed. Deductions that relate to intangible property are also disallowed and deductions that are indirectly related to property outside of New York, such as commissions and legal fees, are disallowed in part by allocating a pro rata portion to such property. The allocation is computed by multiplying the indirect expenses by a fraction equal to the value of the real and tangible property outside New York, plus the intangible property, over the value of the gross estate.

4. **Nothing is Perfect** –

Although the 2014 revisions were a great leap forward, there remain many areas still in need of revision from the standpoint of fairness, equity and parity with the federal system. One such area is New York's failure to adopt portability of the unused exemption amount of the first spouse to die. Portability has been permitted for federal purposes since 2011. Another area is the estate tax "cliff," which denies the entire exclusion amount to estates which exceed 105 percent of the exclusion amount. This could result in a marginal New York estate tax rate of over 170 percent, as follows: assume the basic exclusion amount is $5.25 million, and that the taxable estate is $5,512,500, which exceeds the basic exclusion amount by 105 percent. This estate would owe $452,300 of New York estate tax. If the estate had been worth only $262,500 less, or $5.25 million, the New York estate tax would have been zero. The additional assets of $262,500 generate an estate tax of $452,300. One potential method to reduce the impact of this cliff effect would be to draft a formula-based charitable gift that would eliminate the cliff effect. In the above example, a $262,500 charitable bequest would result in tax savings of $189,800. Care would have to be taken, however, not to go overboard by failing to "cap" the resulting charitable bequest.

Another problem stems from the fact that New York still has not passed legislation permitting state-only QTIP elections. However, on March 16, 2010, the Department of Taxation and Finance issued a statement interpreting current law as permitting a state-only QTIP under two specific circumstances: if no Federal estate tax return was required to be filed, because the value of the gross estate was below the Federal estate tax filing threshold; or, if there was no Federal estate tax in effect in the year of death (i.e., in 2010).[15] Further guidance was issued by the Tax Department the following year clarifying that the state-only QTIP election will not be permitted when a federal return is filed for any reason, including a federal filing solely to make a portability election.[16] So once again, the best advice is to stay alive . . . at least until 2019 that is. And you don't even have to be a non-resident to wish for this.

5. **Stay Tuned** –

Tomorrow is another day.

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1. A careful reading of Sections 952 and 960 as they existed prior to February 1, 2000 indicates that similar problems could have been encountered during that era, but were less likely to have surfaced because New York's tax almost always exceeded the available state death tax credit in those years.
2. Charles D. Fox IV, Robert C. Pomeroy and Susan L. Abbott, "Ramification for Estate Planners of the Phase-Out of the Federal State Death Tax Credit: Boom, Bust or Unknown?"
3. Senate 6060-A, later renumbered S.6060-B; Assembly 9560-A, later renumbered A.9560-B.
4. The Department was true to its word in the "China expatriate" estate (*see* IV(2), *supra*), and canceled its $93,468.97 assessment and fixed the tax at $22.71.
5. NY Tax Law § 960.
6. http://www.tax.ny.gov/pubs_and_bills/advisory_opinions/estate_AO.htm
7. NYS Dept. of Taxation and Finance Advisory Opinion TSB-A-10(1)M (April 8,2010).
8. NYS Dept. of Taxation and Finance Advisory Opinion TSB-A-11(1)M (October 12, 2011).
9. NYS Dept. of Taxation and Finance Advisory Opinion TSB-A-00(1)M (June 5, 2000).
10. NYS Dept. of Taxation and Finance Advisory Opinion TSB-A-01(1)M (July 31, 2001).
11. NYS Dept. of Taxation and Finance Advisory Opinion TSB-A-08(1)M (October 24, 2008).
12. NYS Dept. of Taxation and Finance Advisory Opinion TSB-A-15(1)M (May 29, 2015).
13. NYS Dept. of Taxation and Finance Technical Memorandum TSB-M-14(6)M (August 25, 2014).
14. NYS Dept. of Taxation and Finance Technical Memorandum TSB-M-15(4)M (October 27, 2015).
15. NYS Dept. of Taxation and Finance Technical Memorandum TSB-M-10(1)M (March 16, 2010).
16. NYS Dept. of Taxation and Finance Technical Memorandum TSB-M-11(9)M (July 29, 2011).

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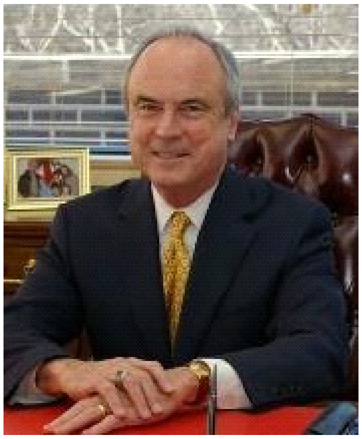

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