



New York State – 2014-2015 Budget Affecting Trusts and Estates

On March 31, 2014, the Governor of New York State signed into law the New York State Budget for 2014-2015 (the Budget) effective April 1, 2014. It includes the most significant changes to the New York estate tax law in more than a decade. The Budget incorporates recommendations proposed in December 2013 by the New York State Tax Reform and Fairness Commission and the New York State Tax Relief Commission (the Commissions) after a comprehensive review of New York State's tax structure. This *Alert* summarizes those aspects of the Budget that are most relevant to New York resident clients and estate planners, including changes to the New York estate tax and to the income taxation of New York trusts.

1. Increased New York Estate Tax Exemption; Phase Out of Exemption

For 2011 and thereafter, the federal estate tax exemption is \$5,000,000, adjusted for inflation. The inflation adjusted amount for 2014 is \$5,340,000. The New York State estate tax exemption, however, has been at \$1,000,000 since February 2000.

The Commissions recognized that the New York estate tax may be a factor in taxpayer migration from New York to other states that do not impose an estate tax. New York is one of only 17 states to impose either an estate tax or an inheritance tax, and only two states currently have an estate tax exemption below \$1,000,000.¹ The Commissions noted that the \$1 million exemption probably was too low, not

¹ The two states with a state estate tax exemption below \$1 million are New Jersey and Rhode Island. In addition to New York, eleven states and the District of Columbia have separate estate tax regimes with state estate tax exemption amounts ranging from \$338,333 to \$3.5 million and maximum estate tax rates ranging from 7% to 19%. Six other states have an inheritance tax in lieu of a state estate tax. Maryland and New Jersey impose both an estate tax and an inheritance tax.

having kept pace with the rise in home values, thus causing many middle income New Yorkers to become subject to New York estate tax.

The Budget addressed these concerns by providing for a gradual increase of the New York estate tax exemption, as follows:

For decedents dying on or after	Exemption Amount
April 1, 2014 and before April 1, 2015	\$2,062,500
April 1, 2015 and before April 1, 2016	\$3,125,000
April 1, 2016 and before April 1, 2017	\$4,187,500
April 1, 2017 and before January 1, 2019	\$5,250,000

As of January 1, 2019, the New York exemption amount will be equal to the federal exemption amount. The Tax Relief Commission determined that the increased exemption would exclude 90% of all New York estates from New York estate tax.²

The Budget, however, provides for the exemption to be rapidly phased out for estates that exceed the exemption amount. The benefit of the exemption is eliminated in its entirety for estates worth more than 105% of the applicable exemption. Accordingly, if a New York taxable estate exceeds the exemption amount by 5%, the entire taxable estate will be subject to the New York estate tax. This “cliff” effect not only means that wealthier New Yorkers receive no estate tax reduction under the new law, but also produces some unexpected consequences.

Consider the following example: An unmarried individual dies on May 1, 2014, when the New York exemption is \$2,062,500. Five percent of the exemption amount is \$103,125. If the decedent’s estate is valued at \$2,165,626 (\$1 over the 5% cliff), the New York estate tax will be \$112,050. Had the decedent’s estate been valued at exactly \$2,062,500, the New York estate tax would have been \$0. Thus, a \$103,126 increase in value of the taxable estate produces a New York estate tax in excess of 100% of the additional \$103,126. In 2018, the result is even more pronounced. If the decedent’s estate is valued at \$5,512,501 (\$1 over the 5% cliff), the New York estate tax will be \$452,300. Had the decedent’s estate been valued at \$5,250,000, the New York estate tax would have been \$0. Thus, a \$262,501 increase in value of the gross estate results in a tax on that additional value of 173%.

2. Potential Planning to Avoid the Cliff

An unmarried New Yorker might consider providing for a deductible charitable gift sufficient to reduce the New York estate tax to an amount that reduces or eliminates the cliff effect. Another possibility is to authorize the beneficiaries of the estate to execute a disclaimer so that the cliff amount would pass to charity, thereby eliminating the New York estate tax. The beneficiaries would receive a larger inheritance were such planning implemented. If the decedent is married, the excess value may pass to the surviving spouse in a manner that qualifies for a New York marital deduction, thereby avoiding the cliff effect.

² Although a reduction of the maximum rate to 10% was considered, it was not adopted and the top rate remains 16%.

3. Add Back of Gifts to New York Gross Estate

In 2014, an individual may make gifts of up to \$5,340,000 without the imposition of a federal gift tax. For a couple, the maximum amount is \$10,680,000. Because New York, like every other state except Connecticut, does not levy a gift tax, such transfers would not be subject to a New York gift tax. Prior to the enactment of the Budget, lifetime gifts also would escape New York estate and generation-skipping transfer taxes because lifetime gifts were not taken into account in computing those taxes. Therefore, New Yorkers whose potential estates exceeded the federal exemption amount could avoid New York estate tax by making lifetime transfers (even in contemplation of an imminent death). Although a federal gift tax might be due (in lieu of a federal estate tax that otherwise would be payable on the transferred amount), in general, the gift would not be subject to any New York estate tax.

The Budget contains a provision to reduce the potential erosion of New York estate tax achieved by making such gifts. The value of gifts made within three years of death by a donor who was a New York resident at the time the gifts were made must be added to that donor's gross estate for New York estate tax purposes. The provision applies to gifts made on or after April 1, 2014 and before January 1, 2019. This provision appears to apply to gifts by a New Yorker of real estate and tangible property not located in New York, which property, if owned at death, would not be subject to New York estate tax.³ Thus, a gift of such property may create a New York estate tax that would not otherwise have been due had the gift not been made. In addition, the New York estate tax on gifts made within three years of death appears not to be eligible for the federal estate tax deduction allowed for the payment of state death taxes. The federal estate tax deduction for state death taxes only is available for taxes paid on property included in the decedent's estate and the decedent's gifts on which New York estate tax is imposed are not included in the decedent's federal gross estate.

4. New York Income Taxation of Exempt Resident Trusts

A. Taxation of INGs

A New York resident trust is one that is created by an individual domiciled in New York when the trust becomes irrevocable or under the will of a New Yorker. A New York resident trust is not subject to New York income tax, however, if all three of the following conditions are met (an Exempt Resident Trust): (i) all of the trustees are domiciled outside of New York; (ii) all real and tangible trust property is located outside of New York; and (iii) all trust income and gain is derived from sources outside of New York.

A New York resident may create an Exempt Resident Trust in another state to avoid the payment of New York income tax on the trust property. Certain Exempt Resident Trusts were designed to obtain this result even if the donor still had access to the funds and did not make a completed gift upon creating the trust (a so-called, Incomplete Gift Non Grantor Trust or ING trust).

In order to address this perceived loophole, the Budget provides that an ING established by a New York resident will be treated as a grantor trust for New York income tax purposes (even if it is not so treated

³ Certain gifts made by a non-resident within three years of death also may be subject to inclusion in the non-resident's gross estate. The three-year rule applies to gifts of real estate and tangible personal property located in New York and intangible personal property employed in a New York trade, business or profession (the intangible property would not be subject to New York estate tax had the non-resident retained such property until death). The inclusion of such gifts by nonresidents appears to only apply to gifts made during a time the decedent was a resident of New York.

for Federal income tax purposes). Accordingly, effective as of January 1, 2014, all items of income, gain and loss of an ING will be includible in the grantor's New York gross income.

B. Distributions to Beneficiaries of Accumulated Income

The Budget imposes an increased New York income tax on beneficiaries of Exempt Resident Trusts that are not INGs (for example, trusts that receive a completed gift at the time of creation). New York beneficiaries will now pay New York income tax not only on distributions of current trust income but also on distributions of accumulated trust income. Any accumulated income will be included in a New York beneficiary's gross income in the year of receipt. There is no interest charge on the accumulated income tax and the beneficiary will be entitled to a credit for income taxes paid to other jurisdictions.

The Budget changes generally are effective immediately but the tax will apply only to distributions made on or after June 1, 2014 of income accumulated on or after January 1, 2014. The trustee of an Exempt Resident Trust with New York beneficiaries should consider making distributions before June 1, 2014, to avoid the accumulated income tax.

C. Eliminate the Generation-Skipping Transfer Tax

The Budget repeals the New York generation-skipping transfer tax, which was enacted in 1999, effective April 1, 2014.

Planning Under the New Law

New York resident married couples can continue to defer New York estate tax by providing, upon the death of the first spouse to die, for (1) a trust for the benefit of the surviving spouse to be funded with the maximum amount that is exempt from New York estate tax, thereby taking advantage of the then available New York estate tax exemption, and (2) the balance of the property to pass to the surviving spouse, either outright or in trust. To the extent an individual does not make use of the full federal estate tax exemption, "portability" is available for federal gift and estate tax purposes.⁴ Portability permits a deceased spouse's unused federal exemption amount to be inherited by the surviving spouse to be used by him or her to offset any future federal gift or estate taxes payable by the surviving spouse. Unlike the federal exemption, the New York exemption is not portable.

New York residents also can continue to make gifts of up to the federal gift tax exemption amount (including, if applicable, any such exemption amount inherited from a deceased spouse), without incurring federal or New York gift taxes. If a New York resident survives the 3-year look back period, the gift will not be added to the New York gross estate. In addition, other advantages of making gifts continue to apply. For example, income generated by the gifted property and appreciation in the value of the property after the date of transfer will be removed from the donor's future taxable estate. The benefit should be weighed against the benefit of receiving a potential step-up in basis for the gifted property at the donor's death, if the property has a low income tax basis relative to its value.

A New York resident can no longer avoid New York income tax by transferring assets to an ING trust. However, it still may be advantageous for a New York resident to make completed gifts to an Exempt Resident Trust. Although any New York beneficiary of the trust would eventually pay New York income tax on distributions, the taxes are deferred until the distribution actually takes place without any interest

⁴ Portability is not available for the federal generation-skipping transfer tax purposes.

charge or penalty. If the beneficiary is not a New York resident, no New York income taxes would be payable on the distribution of accumulated income.

The new income tax laws applicable to Exempt Resident Trusts add a new layer of complexity for New York taxpayers. Therefore, the continued viability of an Exempt Resident Trust should be considered, especially in the case of an ING that will no longer provide the intended tax benefits. Serious consideration should be given to the liquidation of a New Yorker's ING trust prior to June 1, 2014.

Greenberg Traurig, LLP is committed to working with clients and their advisors to plan and effect strategies for individuals impacted by these far reaching changes in the New York and estate and income tax laws.

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