NEW YORK ESTATE TAX AND ITS IMPACT ON ESTATE PLANNING FOR NEW YORK RESIDENTS

General Planning Memorandum

Summary – New York imposes an estate tax on its residents, which is in addition to the federal estate tax. As a result, overall estate taxes for New York residents are greater than for residents of many other states.[1] This additional tax burden can complicate estate planning for New Yorkers. This memorandum summarizes the New York estate tax, discusses how it is related to the federal estate tax, and addresses specific estate planning issues connected to the New York estate tax which affect New York residents. These issues are particularly important for: (1) married New Yorkers, whose estate plans should provide flexibility to handle the separate New York and federal estate tax exemption amounts; and (2) any New Yorker who is considering moving out of New York (and changing domicile) to a state imposing less onerous taxes.

Background – Effective as of December 2012 year end, Congress enacted tax legislation making permanent major changes affecting estate planning. In general, this legislation should provide greater long term certainty for the federal estate, gift and generation-skipping transfer ("GST") tax and create a climate of greater stability than in more recent years for long term estate planning.[2] State estate taxation is affected by the 2012 tax act, which includes legislation confirming on a permanent basis, the conversion (originally part of the 2001 tax act) of the state death tax credit against federal estate tax into a deduction. As a result, many states now impose a state estate tax equal to the amount of the maximum credit which was allowed against federal estate tax for state estate taxes through 2001.[3]

New York Estate Tax - New York is among the many states which impose a state estate tax. Under New York law, the New York estate tax is computed by reference to the maximum credit for state estate taxes against the federal estate as it was in effect in 1998. Under current federal estate tax law, estates may claim a deduction for state estate

[1] Roughly one-third of the states have enacted a state death tax.

[2] The 2001 tax act phased in lower federal estate tax rates and higher exemption levels over 9 years and a 1 year repeal of the estate tax in 2010, but with return to the pre-2002 estate tax scheduled for 2011. In late 2010, tax legislation was enacted to reinstate the federal estate tax for 2 years through 2012, with a 35% rate and a $5,000,000 exemption base.

[3] Prior to the 2001 tax act, most states, including New York, imposed state estate tax equal to the maximum allowable state estate tax credit. This "pick-up" tax provided significant state tax revenue for the states but did not impose any additional overall tax burden. The 2001 tax act significantly reduced the federal estate tax rates and increased the federal exemption. However, the 2001 tax act reduced the cost of the federal estate tax change to the federal government by eliminating the state death tax credit against federal estate tax, and replaced it with a deduction for state estate taxes. Before the 2001 tax act, the federal estate tax was reduced by a dollar for dollar credit for state estate taxes. The amount of this credit was limited by a federal table based on the size of the estate. On account of the 2001 tax act, most states were confronted with potential for substantial loss of state revenues. Many states reacted with state estate tax laws enacted to prevent loss of state estate tax revenues and continue to impose a tax at the same or similar "pick-up" tax rates.

taxes paid; however, a deduction from federal estate tax provides a significant lower benefit which than was provided by the credit.

The New York estate tax substantially increases the overall taxes imposed on estates of New York residents. While the exemption for federal estate tax is $5,340,000 in 2014 and adjusted for inflation in future years, the New York estate tax applies to all taxable estates that exceed $1,000,000. The federal estate tax rate is 40%, and the New York rate is graduated, starting at 6.4% and increased to 16% on taxable estates over $10,000,000, for a maximum net effective combined rate of 49.6%. The chart below computes the total estate tax burden (federal and state taxes) for a New York decedent, and also a decedent residing in a state that does not impose a state estate tax, such as Florida. Each case assumes death in 2014 and is based on the value of each indicated taxable estate.[4]

Taxable Estate	**New York Resident**	**Florida Resident**	**Tax Differential**
$ 1,000,000	-	-	-
$ 2,000,000	$ 99,600	-	$ 99,600
$ 5,340,000[5]	$ 431,600	-	$ 431,600
$ 10,000,000	$ 2,504,560	$ 1,864,000	$ 640,560
$ 20,000,000	$ 7,464,080	$ 5,864,000	$1,600,080

Tax Deferral for Married Persons - Estate plans of married persons typically defer the payment of estate tax until the death of the surviving spouse by taking advantage of the unlimited marital deduction. Accordingly, the New York estate tax generally will have more significant impact at the death of the surviving spouse. However, the New York estate tax also complicates estate planning for a married couple at the death of the first to die. This is because estate planning for married couples typically involves the creation of an "estate tax exemption trust" for the benefit of the survivor under the estate plan of the first to die so as to utilize the estate tax exemption of each spouse at his or her respective death. This planning is more straightforward for residents of states which do not impose a state estate tax. Typically, the estate plan of the first to die creates an estate tax exemption trust in the amount tied to the federal exemption -- $5,340,000 in 2014 -- and the balance of the estate passes to the survivor, either outright or in trust structured in a manner eligible for marital deduction treatment deferring estate tax until the death of the survivor. However, for residents of states such as New York which impose a state estate tax, planning along these lines typically

[4] The federal estate tax exemption is reduced for lifetime taxable gifts beyond the $14,000 annual per donee gift tax exclusion, and the chart assumes none. Any estate taxes paid to another state for real estate located in that state would be credited against New York estate taxes.

[5] A federal taxable estate of $5,830,455 would produce no federal estate tax in 2014 but a New York estate tax of $490,455 – that is, $58,855 more in estate taxes than if the taxable estate were $490,455 lower at the federal estate tax exemption level of $5,340,000. For technical reasons, this differential is important in estate tax exemption trust planning for married persons (discussed below).

involves greater complexity and is even more important given the higher overall incidence of estate taxation on account of the state estate tax.

New York's exemption amount of $1,000,000 is lower than the federal estate tax exemption amount, meaning that some New York estate tax will be payable on the death of the first spouse to die if the full federal estate tax exemption amount is then used. Accordingly, it is often appropriate for the estate planning documents to set the estate tax exemption trust amount at the lower New York exemption level, and to provide flexibility through additional trust provisions to pay some New York estate tax by post-mortem decision in connection with the estate administration.[6]

A recent change (first enacted in 2011) in the federal estate tax law is so-called "portability" for federal estate tax exemption planning. Portability allows the surviving spouse to utilize any unused federal estate tax exemption from the estate of the first spouse to die, without the necessity for a federal exemption trust under the predeceasing spouse's estate plan. Because there is no portability under New York law, the estate plan of a married New Yorker should at least have an estate tax exemption trust (or, alternatively, a bequest to other family members) equal to the New York exemption ($1,000,000). If no trust provisions are created beyond the New York exemption amount, the balance of the federal exemption may be preserved through portability. Portability has disadvantages, however, most notably that principal appreciation between the deaths of the spouses is not protected from estate tax in the survivor's estate.[7]

Change of Residency - Many retired New York residents and residents of other states which impose a state estate tax may consider planning opportunities that may reduce or eliminate state estate taxation. One common technique is to change residency

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[6] To take this into account, there may be provision in the estate plan of the first to die for flexibility in connection with post-mortem planning to utilize the full federal exemption amount (even though this has the potential to incur some New York estate tax) by separating the federal exemption amount disposition into two separate trusts. Each spouse should have in his or her own name assets at least equal to the federal estate tax exemption amount in the year of death. One trust is tied to the New York exemption -- $1,000,000 -- and the other trust is tied to the balance of the federal exemption -- $5,340,000 (in 2014) less the $1,000,000 New York exemption, or $4,340,000. The trust tied to the differential between the two exemption amounts is structured to permit marital deduction treatment to be elected for federal estate tax purposes. The trust structure for the differential amount then provides flexibility to elect to avoid state estate tax upon the death of the first to die (by reason of the state estate tax exemption being smaller than the federal exemption), and also to permit the position to be taken, relying on certain current tax law regulatory authority, that there should be no estate tax (federal or New York) upon the survivor's death on the trust assets. While this presents flexibility for post-mortem planning at the death of the survivor to effectively take the position there will be an enhanced New York exemption in the federal exemption amount available from the predeceasing spouse's estate, there may be risk that the IRS may deny use of the federal exemption to the extent greater than the New York exemption amount.

[7] Another disadvantage is that use of portability makes unavailable the potential option at the death of the survivor to effectively take the position that there will be an enhanced New York exemption in the amount of the federal exemption amount available from the predeceasing spouse's estate (discussed above). Also, portability is not available for the GST exemption for federal generation-skipping transfer ("GST") tax purposes.

to a state that does not impose state estate tax, such as Florida.[8] Change of residency is a serious matter – in New York, the New York tax authorities in some cases vigorously audit tax returns where change of residency is claimed. Where a change of residence is effective, there still may be New York estate tax on New York real property owned by a former New York resident.[9]

Lifetime Gift Strategies - There are a number of established techniques which a New York resident (without change of residency) may use during lifetime estate planning to reduce the long term estate tax burden under current law. These techniques include: full use of the annual per donee gift exclusion each year ($14,000 in 2013, which for a married couple is available to each spouse); irrevocable life insurance trust; qualified personal residence trust ("QPRT") for personal residence planning; and family limited partnership, LLC or grantor retained annuity trust ("GRAT") planning for marketable securities, closely held business interests, or other illiquid family assets. These techniques are available to residents of all states. There is an additional gifting option relating to the New York estate tax for a New York resident, particularly one who is of very advanced age or terminally ill. This involves making a substantial taxable gift (either outright or in trust) to family members. The benefit from this gift is that New York does not impose a gift tax, nor does current New York estate tax law take lifetime gifts into account in its tax transfer base at death. Depending on the size of the gift, a significant reduction of New York estate tax may be achieved.[10]

New York "GST" Tax - Another issue to consider is that the generation-skipping transfer ("GST") tax exemption for New York law purposes is lower than the federal -- $1,430,000 in 2013 and adjusted by an annual inflation factor in future years. The federal GST exemption amount is set at $5,340,000 in 2014 and is likewise adjusted for future inflation. Accordingly, a separate New York GST tax may be applicable to federal GST exemption trust property at deaths of children with respect to the excess over the applicable lower New York GST exemption for a trust created by a New York resident.[11]

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[8] Florida's constitution contains a provision under which it appears that a state estate tax may not be enacted unless there is a state estate tax credit in effect under the federal estate tax on a dollar for dollar basis. In addition to potential estate tax reduction, Florida residency may also make available significant income tax and real property tax advantages.

[9] Lifetime planning techniques are available, however, to eliminate this taxation.

[10] Where lifetime gifts are made up to the federal exemption amount, there can be a saving of New York estate tax at death comparable to the result where the position for an enhanced New York exemption is taken (discussed above), but without the risk. Also, for federal estate tax purposes, even for a gift is so large as to incur federal gift tax (applicable to aggregate lifetime gifts over $5,340,000, and adjusted for future inflation after 2014), the gift may not produce adverse overall federal transfer tax consequences, because the federal estate tax is reduced by the gift tax paid. Moreover, gifting can result in a significant long term overall reduction in federal estate and gift taxes if the donor lives more than three years after the date of the gift, because then the gift tax is not taken into account at death for purposes of the federal transfer tax base.

[11] The New York GST tax rate on taxable distributions and terminations is 2.75%, which is 5% of the federal GST tax rate of 55% in effect under prior law in 2001 (formerly eligible for a credit against the federal GST tax). The New York GST tax is imposed on taxable distributions and terminations from a trust. Unlike the federal GST tax, there is no New York GST tax on direct skips; however, in calculating the total New York exemption available to an individual, direct skips will be deducted from the exemption amount. Since New York does not conform to the changes enacted by federal tax legislation in 2001, the NY rate remains at 2.75% without regard to the date of the generation-skipping transfer.

Prospective New York Legislation - Legislation has recently been proposed by Governor Cuomo under a four year phase-in which would (i) decrease the New York maximum estate tax rate to 10% (from the current 16%); (ii) increase the New York estate tax exemption from $1,000,000 to $5,250,000 and (iii) take into account lifetime gifts.[12] Also, this proposed legislation would repeal the New York GST tax. Although the future of this proposed legislation is uncertain, properly drawn estate planning documents should take into account the possibility that changes in the New York estate tax along these lines may be enacted.

Conclusion - Other planning opportunities and considerations may be applicable for specific client situations in addition to those outlined above. It is important to review all estate plans periodically and to take into account the ever present prospect of tax law changes affecting estate planning.

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[12] This provision would apply to lifetime gifts made on or after April 1, 2014, which would be the effective date of the proposed legislation.