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# Changes to New York's Estate and Trust Income Tax Laws

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Just as we were getting used to the permanent federal estate tax changes enacted in 2013, the New York Legislature and Governor Andrew Cuomo made significant changes to New York's estate tax and trust income tax laws. Once again, trusts and estates practitioners are required to adapt to an ever changing tax landscape. These new laws were signed into law by Cuomo, effective April 1, 2014, as part of the implementation of the 2014-2015 budget for New York. According to Cuomo, a key objective is to provide tax relief to New Yorkers and prevent them from leaving for states with more generous estate tax laws. This article summarizes the estate tax and trust income tax provisions in the new law. As described below, there are a few controversial provisions which put into question whether these new laws will ultimately have the effect of keeping New Yorkers from leaving.

## Estate Tax Exclusion Amount

The major estate tax change adopted by the new legislation is an increase in New York's basic exclusion amount over the next five years. In general, the basic exclusion is the amount that a New York decedent can pass to a non-spouse without being subject to a New York estate tax. Prior to the new law, this amount had long been $1 million.

As of April 1, 2014, and until March 31, 2015, the exclusion is $2,062,500 per decedent. Over the next few years, the exclusion is scheduled to increase as follows: (i) $3.125 million per decedent from April 1, 2015, to March 31, 2016, (ii) $4,187,500 per decedent from April 1, 2016, to March 31, 2017, and (iii) $5.25 million per decedent from April 1, 2017, to Dec. 31, 2018. Then, from Jan. 1, 2019, forward, the exclusion is scheduled to be equal to the federal exemption, which is projected to be approximately $6 million after adjustments for inflation.

The increased exclusion amount is significant and arguably overdue when compared to how the federal exemption has increased over time. Explaining the exclusion to clients and planning for the exclusion will be less complicated once New York is in parity with the federal exemption. However, until then, planners need to consider how the change in the exclusion over the next few years will impact a client's estate and to what extent current planning needs to take into consideration these changes.

Also, existing plans with formula clauses to fund credit shelter trusts up to New York's exclusion amount should be revisited to ensure that the original intent of those estate plans are maintained. Take, for example, a non-traditional estate plan for a $4 million dollar estate that funds a credit shelter trust up to the New York exclusion amount for the benefit of children from a first marriage and passes the remainder of the estate to the spouse from a second marriage.

Under the old law, $1 million pass to the children and $3 million pass to the spouse. However, under the new law, the amount funding the credit shelter trust will eventually consume the entire estate as the date of death approaches April 1, 2016. Given this unintended result, plans that contain formulas based on New York's exclusion should be reviewed.

While the next few years will present complexities due to the changing exclusion amount, the increase in the exclusion is positive for most New Yorkers and will result in many more estates being below the threshold which triggers an estate tax. Unfortunately, the new law is not positive for all New Yorkers. This is because the new law includes a phase out of the exclusion for taxable estates that exceed the exclusion amount at the time of death. To understand this, a brief review of the new law is helpful.

In determining the estate tax, there are two components—the tax computation and the applicable credit amount. The tax computation is determined by a rate table, which computes the tax according to the size of the taxable estate. For decedents dying between April 1, 2014, and March 31, 2015, the rates range from 3.06 percent on taxable estates not over $500,000 to 16 percent on taxable estates over $10.1 million. The applicable credit amount is calculated based on the size of the taxable estate and the exclusion amount in place at the time of death. It results in a credit against the computed tax, thereby reducing the estate tax due.

Under the new law, the credit begins to decrease once the taxable estate exceeds the exclusion amount and is not available once the taxable estate exceeds 105 percent of the exclusion amount —referred to as a phase out of the exclusion.

Applying the new law and assuming a date of death of Jan. 1, 2015, when the basic exclusion is $2,062,500, there are essentially three scenarios that can apply to a New York decedent. The first scenario consists of a decedent with a taxable estate that is less than or equal to the exclusion amount. Here, the credit is equal to the amount of tax that would otherwise be due under the tax table. Thus, there is no estate tax as the credit washes out the computed tax. The next scenario is for a decedent with a taxable estate that exceeds the exclusion amount by less than 105 percent. Here, the credit is determined by a calculation which produces a decreasing credit as the size of the taxable estate increases.

For example, the tax computation according to the tax table is $106,800 for a decedent with a taxable estate of $2.1 million (101.8 percent of $2,062,500). In determining the credit, the new law requires that the difference between the taxable estate and the exclusion amount ($37,500) be divided by 5 percent of the exclusion amount ($103,125). This provides a phase out percentage, in this case 36 percent ($37,500/$103,125), and requires that the credit be calculated by computing the tax on the remaining 64 percent of the exclusion amount ($1,312,500). Accordingly, the credit would equal $57,487.50 and would reduce the computed tax of $106,800 to generate an estate tax of $49,312.50. This results in a tax rate of 132 percent ($49,312.50/$37,500) on the portion of the taxable estate that exceeds the exclusion amount.

The final scenario consists of a decedent with a taxable estate that equals or exceeds 105 percent of the exclusion amount (i.e. a taxable estate of $2,165,625 or more). Here, no credit is allowed which effectively phases out the exclusion and the tax computation on a taxable estate of $2,165,625 produces an estate tax of $112,050. This results in a tax rate of 109 percent ($112,050/$103,125) on the portion of the taxable estate that exceeds the exclusion amount.

As demonstrated above, the phase out is anything but gradual. Some would even argue that it is punitive. Given the effect the phase out has on the more wealthy New Yorkers, there is a question as to how this "tax cliff" reduces any incentive for New Yorkers to leave the state. When the budget was being proposed, the phase out triggered criticism across the trusts and estates community. Only time will tell if this controversial provision remains in its current form or is changed by some future amendment. For now, careful consideration should be given to reduce a taxable estate, if possible, to remain under the exclusion amount and avoid the phase out.

# Portability

Despite the significant changes to New York's estate tax, the new law failed to implement portability which applies for federal estate tax purposes since 2011. In general, portability enables the estate of a surviving spouse to utilize the unused federal gift and estate tax exemption amount of the first spouse's estate. Since this is not available in New York, if a couples' combined taxable estate exceeds one New York exclusion amount, it continues to be important to balance their estates so sufficient assets are titled to each of them individually. If not, a couple runs the risk of the non-monied spouse dying first and wasting his/her full New York exclusion amount.

Additionally, it is critical that estate plans continue to pass assets to a surviving spouse utilizing a credit shelter or bypass trust. These trusts not only provide creditor protection benefits, they are a planning tool which allows a couple to take advantage of the New York exclusion on the first death and ensures that the assets that fund the trust, and the appreciation of those assets, avoid estate taxation in the surviving spouse's estate.

# Gross Estate Expanded

Another significant change introduced by the new law is the inclusion of certain lifetime gifts when computing a New York resident's gross estate at death. These gifts are limited to those made by the decedent: (i) when the decedent was a resident of New York, (ii) within three years of decedent's death, and (iii) between April 1, 2014 and Dec. 31, 2018. Additionally, the new law appears to include gifts of real property and tangible property having a situs outside of New York. This is inconsistent with existing law which provides that these assets are not subject to New York's estate tax if they were owned by the decedent at death. Given this disparity in tax treatment, the new law should be clarified or amended to treat these types of assets consistently.

With the passage of the new law, New York continues to not impose a gift tax. However, gifts made during a decedent's lifetime may become subject to New York estate tax once the gifts that meet the above criteria are added to a decedent's gross estate. Given the changes related to lifetime gifts, planners must carefully consider the potential estate tax implications when making gifts to bring a New York estate below the New York exclusion amount. This is particularly important for clients who have a real risk of dying within three years because they are elderly or not in good health. Additionally, unintended consequences may arise when lifetime gifts are brought back into the gross estate. For example, if the donees of lifetime gifts are different from the beneficiaries of the estate, the beneficiaries may bear the burden of paying the estate tax on assets they did not receive.

Finally, it is unclear why gifts made on or after Jan. 1, 2019, are excluded. It would seem more logical that gifts would be excluded during the time frame when the New York exclusion is being phased in (from 2014 to 2019). Then, once fully phased in and equal to the federal exemption in 2019, lifetime gifts within three years of death would be brought back because, at that time, New Yorkers will be able to take advantage of an exclusion amount close to $6 million.

## Trust Income Tax Changes

In addition to the changes in the estate tax and the expansion of the gross estate by way of certain lifetime gifts, the new law contains income tax changes for certain trusts. An incomplete gift non-grantor trust (ING) is one such trust affected by the new law. An ING is an irrevocable domestic asset protection trust utilized not only for asset protection but also to minimize or avoid New York state income tax. These trusts are created by New York residents in a jurisdiction (such as Delaware) that does not impose a state income tax if the trust is for the benefit of non-residents. The assets transferred to an ING are not considered taxable gifts for federal gift tax purposes and the grantor can be a permissible beneficiary.

Recognizing this loophole, the new law provides that an ING will be treated as a grantor trust for New York income tax purposes. Accordingly, a New York grantor will now be required to report an ING's income on the grantor's individual tax return and will be responsible for the income tax liability. This will undoubtedly cause confusion as these trusts will now be reported as a grantor trust for New York income tax purposes and a non-grantor trust for federal income tax purposes. The new law is effective immediately for tax years beginning on or after Jan. 1, 2014, but excludes income earned by an ING that is liquidated before June 1, 2014.

The other type of trust affected by the new law is a New York resident trust. These trusts are created by a New York resident and, under the prior law, escaped income tax if during a particular year (i) no trustees were domiciled in New York, (ii) no real or tangible trust property was located in New York, and (iii) there was no New York source trust income. With the passage of the new law, New York resident beneficiaries of these trusts will now be subject to a "throwback tax" on certain distributions.

Specifically, an income tax on the accumulated income of these trusts earned after Jan. 1, 2014, will now be imposed on any income distributed after June 1, 2014, to a beneficiary who is then a New York resident. Excluded from the throwback tax is income earned by the trust in a taxable year which is prior to when the beneficiary (i) turned 21 years of age or (ii) first became a New York resident. In addition to imposing a new tax, advisors and trustees will be faced with the administrative burden of accounting for the throwback tax and preparing informational returns to ensure compliance.

# Conclusion

As a result of the new law, trusts and estates practitioners have a new set of tax changes to consider when working with clients. Some existing planning techniques remain important and others will be replaced or modified to adapt to the changes in the law. The effect of the new estate tax and trust income tax provisions will be mixed. For New Yorkers with an estate over $1 million but under the new basic exclusion amount, the law will result in estate tax savings. However, for more wealthy New Yorkers, they continue to be subject to a top estate tax rate of 16 percent, gifting techniques may have to be limited in the near future, and options for utilizing trusts as income tax avoidance strategies have narrowed. Accordingly, it is not likely that the new law will significantly alter the desires of wealthy New Yorkers seeking to escape to a more tax-friendly state.

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