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Analyzing New York Estate Tax Law as Federal Proposals Loom

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act raised the gift, estate and generation skipping transfer (GST) tax exemptions to $5 million for 2011 and 2012. In fact, these exemptions are $5.12 million in 2012, after adjusting for inflation.

These exemption amounts are scheduled to expire on Dec. 31, 2012. If no new law is enacted, the federal gift, estate and GST tax exemptions will revert back to $1 million, although the GST exemption will be adjusted for inflation going back to 2001. Furthermore, the maximum transfer tax rate will increase from 35 percent to 55 percent.[1]

President Barack Obama recently submitted a budget proposal which would reduce the estate and GST exemptions to $3.5 million and the gift tax exemption to $1 million, effective Jan. 1, 2013. Additionally, the maximum transfer tax rate would be 45 percent.

Other proposals would retain the transfer tax exemptions at $5 million, plus inflation, and keep the transfer tax rate at 35 percent. Even more drastic, presidential candidate Mitt Romney proposes to repeal the "death tax" if he is elected president.

Assume the exemptions remain at $5 million, plus inflation. If so, clients can use careful planning to avoid paying any federal transfer taxes if the taxable estate does not exceed $5 million, plus inflation (or $10 million, plus inflation for married couples). New York residents, however, still must consider the New York estate tax laws.

New York Estate Tax

New York does not have a gift tax, but it does have an estate tax. For New York residents, a New York estate tax is generally owed if the taxable estate (not including adjusted taxable gifts made during lifetime) exceeds $1 million. Unfortunately, the calculation of the New York estate tax is somewhat complicated because of the need to determine the amount of the tentative tax owed by referring to Table A (Unified Rate Schedule) and Table B (Computation of Maximum NYS Credit for State Death Tax Credit) as provided in the New York estate tax return (ET-706).

The first step is to determine the tentative tax under Table A. Start by taking the taxable estate (gross estate less deductions) and add back the adjusted taxable gifts made during lifetime. Then subtract any federal gift tax payable, and the difference represents the amount that is subject to the tentative tax under Table A. Once the tentative tax is calculated, take a maximum deduction of $345,800 (which equates to a $1 million estate tax exemption) and the difference is the tentative taxed owed under Table A.

The next step is to determine the tentative tax owed under Table B. First, subtract $60,000 from the taxable estate which does not include the adjusted taxable gifts. The difference is the adjusted taxable estate for New York State and represents the amount that is subject to the tentative tax under Table B. In computation of the results of Tables A and B, the lower tentative tax will be used to determine the amount of New York State tax owed.

To illustrate, assume a New York resident died with a $1 million taxable estate and had not made any taxable gifts during lifetime. The tentative tax calculated under Table A is $0 because of the $345,800 deduction. The tentative tax under Table B is $33,200. In this case, the New York estate tax is $0—the lower of the two amounts.

If a New York resident died with a $2 million taxable estate (no taxable gifts), the tentative tax under Tables A and B would be $435,000 and $99,600, respectively. Again, the New York estate tax would be the lower of the two amounts, or $99,600.

Interestingly, what if a New York resident died with a $1 million taxable estate but made taxable gifts of $4 million during lifetime? If New York does not have a gift tax and the taxable estate is only $1 million, then would that mean the New York estate tax would be zero by virtue of the $1 million exemption? The answer is no, because you still have to compare the tentative taxes under Table A and B. The tentative tax using Table A is $2,075,000 but the tentative tax using Table B is $33,200. Accordingly, this estate would owe a New York estate tax of $33,200.

Table B will generate a tentative tax once the taxable estate (not including taxable gifts) exceeds $100,000. Table B has increasing marginal tax rates and reaches a maximum rate of 16 percent once the taxable estate exceeds $10.1 million. Table A generates a tentative tax once the amount of the taxable estate and taxable gifts exceed $1 million.

To summarize, a New York estate tax will be owed once the sum of the taxable estate and taxable gifts exceed $1 million and the taxable estate itself is over $100,000. Additionally, Table A generally will be used to calculate the New York estate tax if the sum of the taxable estate and taxable gifts does not exceed $1 million. Table B will be used to determine the New York estate tax in most other instances.

Planning Considerations

Married Couples. Historically, many married couples created a "credit shelter" trust to ensure that the federal estate tax exemption is used when the first spouse dies. Under current law, a married couple may not necessarily need a "credit shelter" trust to shelter assets from federal estate taxes due to the increased exemption amounts and the portability provisions found under the new tax act.[2] Nonetheless, New York married couples may want to consider using an exemption trust to take advantage of the $1 million New York estate taxexemption.

To further examine the potential New York estate tax consequences, suppose husband and wife each own a $5 million taxable estate and made no taxable gifts during lifetime. If husband dies first, one option is to leave everything outright to his surviving spouse. No estate taxes would be owed by virtue of the marital deduction, but now the surviving spouse has a taxable estate of $10 million. If she died shortly thereafter, her estate would pay a New York estate tax of $1,067,600.

One option is for husband to create a $1 million exemption trust and leave $4 million outright to his surviving spouse. If wife died shortly thereafter, her $9 million taxable estate (the $1 million exemption trust would bypass her estate) would be subject to a New York estate tax of $916,400, thereby reducing the New York estate tax by $151,200 when compared to the previous example.

Alternatively, husband could have funded a $4 million New York Qualified Terminable Interest Property (QTIP) trust instead of leaving it outright to his surviving spouse. A New York QTIP trust would allow an estate to take advantage of the marital deduction for New York estate tax purposes, but not federal. A New York estate tax QTIP election, however, only is allowed if a federal estate tax return is not required to be filed. Ordinarily, this would not pose a problem if the estate is too small to file a federal estate tax return.

But what if the executor of the first spouse's estate wanted to take advantage of the portability provisions of the new tax act so that the surviving spouse's estate can take advantage of the first spouse's unused federal exemption. To do so, the executor would have to file a federal estate tax return indicating the election of portability, even though no federal estate tax is due. The New York State Department of Taxation and Finance takes the position that if a federal estate tax return is filed to take advantage of portability but no QTIP election is made on the federal return, then the estate cannot make a QTIP election on the New York estate tax return.[3]

Another option is to equalize the estates of a married couple to minimize the impact of the increasing marginal tax rates. For example, suppose husband dies first and leaves his $5 million estate in a family trust for the benefit of his wife and

children. In this example, husband's $5 million taxable estate would be subject to a New York estate tax of $391,600 but the trust assets can be used to help support the wife during her lifetime. If wife died shortly thereafter, her $5 million estate would be subject to a New York estate tax of $391,600. Stated differently, by equalizing the estates, this married couple paid a combined New York estate tax of $783,200, rather than $1,067,000 if the husband's estate was left outright to the surviving spouse and she died shortly thereafter. This results in savings of $283,800.

Obviously, the actual savings would be dependent on the growth of the assets after the husband dies and how long the wife survives. Furthermore, you should never let "the tax tail wag the dog," especially if the strategy does not coincide with the couple's objective.

Same-Sex Marriage. The Marriage Equality Act became effective in New York on June 24, 2011. As a result, same-sex married couples and different-sex married couples will be treated equally under all New York laws. Accordingly, the same estate tax deductions and elections allowed for different-sex married couples also will be available for same-sex married couples, whether or not a federal estate tax return is filed.[4]

If an individual dies while married to a same-sex spouse, the estate can take advantage of the marital deduction for New York estate tax purposes, even though it would not be recognized under federal tax law. The New York marital deduction can be taken by preparing a separate pro forma federal estate tax return as if the marital deduction was recognized under federal law. This pro forma return must then be attached to the New York tax return.

Lifetime Gifts. As previously indicated, New York does not have a gift tax. Therefore, lifetime gifting can result in further savings.

To illustrate, if a New York resident died with a $5 million taxable estate and never made any taxable gifts then the estate would owe $391,600 in New York estate taxes. If this individual made taxable gifts of $1 million and died with a $4 million taxable estate the New York estate tax would be reduced to $280,400. The larger the gift, the lower the tax. As previously noted, if a New York resident made taxable gifts of $4 million and died with a $1 million taxable estate, the New York estate tax would be reduced to $33,200 which results in a savings of $358,400, when compared to the first example.

Conclusion

The New York estate tax laws will continue to be an important factor for New York residents. It is important for estate planning attorneys in New York to be well versed in these laws and understand the opportunities and the potential pitfalls.

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Endnotes:

1. An additional federal estate tax of 5 percent would be imposed for taxable estates between $10 million and $17.184 million. This surtax would wipe out the benefit of the lower marginal rates. In other words, an estate will be subject to a flat 55 percent transfer tax rate once the taxable estate exceeds $17.184 million.

2. Portability allows a surviving spouse to use a predeceased spouse's unused federal estate tax exemption. This unused exemption, however, would not be adjusted for inflation. Furthermore, portability is schedule to expire on Dec. 31, 2012 unless it is reinstated by new legislation.

3. Technical Memorandum TSB-M-11(9) M, New York State Department of Taxation and Finance, July, 29, 2011.

4. See the instructions for Form ET-706 which is published by the New York State Department of Taxation and Finance (Form ET-06-1).