Client Alert

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Estates, Trusts & Tax Planning

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Recent Changes to New York Estate and Income Tax

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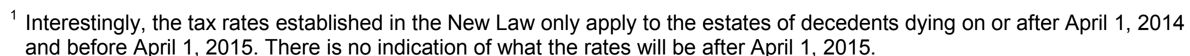
On March 31, 2014, the New York State legislature passed and Gov. Andrew Cuomo signed into law the New York State 2014-2015 Budget Bill (the "New Law"), which contains a number of revisions to the New York State estate tax law and the laws governing the New York income taxation of trusts. Specifically, the New Law (1) gradually increases the New York State estate tax exemption amount over the next five years; (2) includes certain lifetime gifts as part of a decedent's New York taxable estate; and (3) closes two perceived "loopholes" in New York's income taxation of trusts in an effort to recapture income tax that New York was losing from certain resident trusts with non-resident trustees. By increasing the estate tax exemption amount, the New Law increases the number of estates that will pass free of New York State estate tax liability. Larger estates (as described below) will generally be subject to the same New York State estate tax liability as they were under the old law, unless they are required to include certain lifetime gifts as part of their taxable estates.

New York State Estate Tax under the New Law:

Under the New Law, New York State estate tax is computed using tax rates that are substantially the same as the tax rates under the old law. The highest tax bracket under the New Law is 16 percent, the same as it was under the old law.[1] Under both the New Law and the old law, the tentative tax due on a taxable estate over $10,100,000 would equal $1,082,800 plus 16 percent of the excess over $10,100,000.

However, to increase the number of estates that pass free of New York State estate tax, the New Law provides an estate tax credit for certain estates based on a "basic exclusion amount" in effect at the time of



[1] Interestingly, the tax rates established in the New Law only apply to the estates of decedents dying on or after April 1, 2014 and before April 1, 2015. There is no indication of what the rates will be after April 1, 2015.

the decedent's death. The basic exclusion amount is set to increase gradually over the next five years as follows:

Decedent dying on or after:	Basic exclusion 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

For the estate of a decedent who dies on or after January 1, 2019, the basic exclusion amount will equal the federal basic exclusion amount indexed for inflation (currently $5,340,000).

A taxable estate that is less than or equal to the New York basic exclusion amount owes no New York State estate tax (because the New Law provides an estate tax credit for such estates in an amount that equals the tax the estate would otherwise owe). A reduced credit is available for a taxable estate that exceeds the New York basic exclusion amount by 5 percent or less of such basic exclusion amount. No credit is allowed, however, for a taxable estate that exceeds 105 percent of the New York basic exclusion amount. The New Law provides no relief for an estate of that size—it will owe the same New York State estate tax as it would have owed under the old law.

In this way, the New Law has created the perplexing situation whereby a taxable estate of $5,250,000 will owe no New York State estate tax in 2018 while a taxable estate of $5,600,000 will owe $462,800. This effect is referred to as the "cliff" (i.e., the amount over which the benefit of the exclusion is eliminated).[2] As a result, the decedent with a New York taxable estate of $5,600,000 is able to pass only $5,137,200 to his or her heirs whereas a decedent with a taxable estate of $5,250,000 will be able to pass the full $5,250,000.[3]

Inclusion of Certain Lifetime Gifts:

Under the New Law, a New York decedent's gross estate now includes the amount of any taxable gift (not otherwise included in the decedent's gross estate) that the decedent made within three years of his or her death, unless the gift was made: (1) while the decedent was not a New York resident; (2) prior to April 1, 2014; or (3) on or after January 1, 2019. Thus, even though New York does not have a gift tax, New York decedents will not avoid state transfer tax on lifetime gifts made within three years of death (if such gifts were also made between April 1, 2014 and January 1, 2019).

Portability and QTIP Election:

Also significant is that despite practitioners' recommendations, the New Law did not (1) adopt "portability" of the New York exclusion amount, or (2) allow a separate New York QTIP election to be made for New York State estate tax purposes unless a federal QTIP election was also made on any federal estate tax return required to be filed.

[2] Under the old law, there was also an estate tax cliff. The exclusion was $1,000,000, and estates that were larger than $1,100,000 did not receive the benefit of the exclusion. However, unlike the New Law, under the old law the elimination of the benefit of the exclusion never resulted in an estate netting less than the $1,000,000 exclusion amount.

[3] These calculations consider only the New York tax (before taking into account federal tax due). Contrast these calculations with federal estate tax calculations whereby a taxable estate of $5,250,000 in 2014 would owe no federal estate tax but a taxable estate of $5,600,000 would owe $104,000 (before any allowable deduction for state estate tax).

Adopting portability of the New York exclusion amount would have allowed a married couple to use their combined exclusion amounts upon the death of the surviving spouse, as is possible under the federal law. The New Law limits each spouse to his or her own New York basic exclusion amount upon his or her death, and if it is not used by a spouse's estate, it is lost.

If a federal estate tax return is required for an estate, even if only to elect portability, the New Law does not permit an executor to elect a marital deduction for a trust for New York estate tax purposes unless the election to have the trust qualify for the marital deduction is also made for federal purposes. Thus, the executor for a New York decedent's estate is forced to elect a federal QTIP deduction for a trust that would otherwise fall within the federal exclusion amount in order to minimize New York State estate tax.

New York Income Taxation of Trusts:

The New Law also attempts to address two "loopholes" that the New York State legislature perceived with respect to New York income taxation of trusts.[4] The first relates to income tax payable by a New York resident who is a beneficiary of an "exempt resident trust". The second relates to income tax payable by a New York resident who transfers property to an "incomplete gift non-grantor trust" (an "ING trust").

Beneficiary of an Exempt Resident Trust/"Throwback Tax":

An irrevocable trust established by a New York resident (a "resident trust") is generally subject to New York income tax. However, if a resident trust has no New York trustee, no assets located in New York, and no New York source income, it is deemed an "exempt resident trust" and will pay no New York income tax on income the trust earns and accumulates even though the trust pays federal income tax on that income. Prior to the New Law, in a year that a New York resident beneficiary of an exempt resident trust received a distribution of income that had been accumulated over prior years, the beneficiary was only required to include in his or her New York adjusted gross income a portion of the distribution that reflected the net income earned by the trust in the year of distribution.

The New Law attempts to close this "loophole" by requiring a New York resident beneficiary to include accumulated income of the trust not previously taxed in New York ("undistributed net income") in his or her New York adjusted gross income in the year that he or she receives a distribution. In calculating such undistributed net income, the beneficiary may disregard any income earned by the trust in a taxable year prior to the date the beneficiary first became a New York resident or in any taxable year beginning prior to January 1, 2014. In addition, as this New York law is based on the federal provisions, income accumulated by a trust prior to the beneficiary attaining the age of twenty-one is excluded from the undistributed net income that the beneficiary must report.

Incomplete Gift Non-Grantor Trust:

An ING trust, as defined in the New Law, is a trust that satisfies two requirements: (1) it does not qualify as a grantor trust for federal income tax purposes; and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift for federal estate tax purposes (*e.g.*, by the grantor retaining sufficient control over or a beneficial interest in the trust). By establishing an ING trust outside of New York, in a jurisdiction such as Delaware, a New York resident could avoid paying New York income tax on income earned on the trust assets and accumulated by the trust while still retaining some level of control over the disposition of the assets. To curtail this favorable treatment, the New Law provides that such trusts will now be treated as grantor trusts for New York income tax purposes, which means that the income and deductions of the trust will be reported on the grantor's individual New York income tax return.

[4] None of the rules discussed here apply to a "grantor trust", the income of which is taxable to the grantor of such trust.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or one of the authors below.

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