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Trusts and Estates Planning Opportunities Arising From Recent Changes to the New York Estate Tax and Trust Income Tax Regimes

On April 1, 2014, the New York state 2014–2015 budget (the “Budget”) became effective. The Budget includes legislation (the “Budget Legislation”) that makes several significant changes to New York’s estate tax regime and to the income tax treatment of trusts created by New York residents that were exempt from tax under prior legislation (“exempt resident trusts”) and incomplete gift nongrantor trusts (INGs) created by New York residents.

Under the Budget Legislation, New York imposes a tax on a decedent’s entire taxable estate and allows a credit (the “Applicable Credit Amount”) against that tax. The Applicable Credit Amount depends upon the size of the decedent’s taxable estate and the date of death. If the taxable estate does not exceed a certain threshold (the “State Basic Exclusion Amount”), the Applicable Credit Amount will equal the tax, thus resulting in no tax due. If the taxable estate exceeds the State Basic Exclusion Amount, the Applicable Credit Amount phases out very quickly, with the effect that if the taxable estate exceeds the State Basic Exclusion Amount by more than 5%, no credit is allowed. The Budget Legislation sets the State Basic Exclusion Amount at \$2,062,500 for estates of decedents dying on or after April 1, 2014. Over the next four years and nine months, the State Basic Exclusion Amount will increase to equal, approximately, the federal applicable exclusion amount from estate tax, as indexed for inflation (the “Federal Applicable Exclusion Amount”), by January 1, 2019.

The Budget Legislation makes several other notable changes, such as: (1) providing for certain gifts made by a New York resident between April 1, 2014 and January 1, 2019, and also within three years of death, to be included in the decedent’s New York gross estate; (2) repealing the New York state generation-skipping transfer (GST) tax; (3) subjecting the accumulated income of exempt resident trusts to a so-called “throwback” tax once distributed to a New York resident beneficiary; and (4) including the current net income of an ING created by a New York resident in its grantor’s New York state income tax.

The Trusts and Estates Practice at Katten Muchin Rosenman LLP is pleased to provide you with a summary of the Budget Legislation, along with related planning recommendations to consider immediately.

Estate Tax Changes

As explained more fully below, the ultimate effect of the Budget Legislation with respect to the estate tax, once it is fully implemented in 2019, is to provide that New Yorkers with estates that do not exceed the Federal Applicable Exclusion Amount will pay no New York estate tax. Estates over \$1 million (the state exemption amount under prior legislation) and less than or equal to the Federal Applicable Exclusion Amount will avoid paying any New York estate tax, whereas they would have been required to pay New York estate tax under prior legislation. In contrast, estates under \$1 million and larger estates that exceed 105% of the Federal Applicable Exclusion Amount will receive no benefit and no penalty from the Budget Legislation.

Phased Increase to the State Basic Exclusion Amount and the Phase Out of the Applicable Credit Amount

Beginning with the estates of decedents dying on or after April 1, 2014, the State Basic Exclusion Amount will gradually increase over the span of four years and nine months to equal the Federal Applicable Exclusion Amount. The maximum marginal tax rate will remain the same, at 16%. Unlike the federal estate tax regime, however, the Budget Legislation does not allow for portability of either the State Basic Exclusion Amount or the Applicable Credit Amount between spouses.

For New York taxable estates valued at the State Basic Exclusion Amount or less, no estate tax is due (although a New York estate tax return must still be filed if the decedent's New York gross estate exceeds the State Basic Exclusion Amount).

However, if the New York taxable estate exceeds the State Basic Exclusion Amount, the Applicable Credit Amount phases out very quickly, and drops off the proverbial “cliff”—falling to zero—once the New York taxable estate reaches 105% of the State Basic Exclusion Amount (the “Applicable Credit Limit”). By way of illustration, were the New York taxable estate of a decedent who died on April 1, 2017 valued at \$5,250,000 (the State Basic Exclusion Amount for that year), the estate would pay no New York estate taxes; whereas, if the New York taxable estate were valued at \$5,512,500 (the Applicable Credit Limit for that year), the estate would pay \$452,300 in New York estate taxes as a result of the additional \$262,500 in assets over and above the State Basic Exclusion Amount. Note that estates exceeding the Applicable Credit Limit will pay the same amount of tax that they would have paid under prior legislation as a result of changes to the New York estate tax rate tables that were made by the Budget Legislation.

For taxable estates valued somewhere between the State Basic Exclusion Amount and the Applicable Credit Limit, the Applicable Credit Amount decreases by a sum determined by a formula that is based in part on the amount by which the taxable estate exceeds the State Basic Exclusion Amount. To illustrate, were the New York taxable estate of a decedent who died on April 1, 2017 valued at \$5,350,000 (\$100,000 over the State Basic Exclusion Amount for that year), the Applicable Credit Amount would equal \$205,200, and the estate would pay \$227,600 in New York estate taxes because of the additional \$100,000 in assets over and above the State Basic Exclusion Amount.

The State Basic Exclusion Amounts and Applicable Credit Limits for each relevant period are as follows:

Date of Death	State Basic Exclusion Amount	Applicable Credit Limit
April 1, 2014 to March 31, 2015	\$2,062,500	\$2,165,625
April 1, 2015 to March 31, 2016	\$3,125,000	\$3,281,250
April 1, 2016 to March 31, 2017	\$4,187,500	\$4,396,875
April 1, 2017 to December 31, 2018	\$5,250,000	\$5,512,500
January 1, 2019 or later	Approximately equal to the Federal Applicable Exclusion Amount ¹	State Basic Exclusion Amount, plus 5%

Inclusion of Gifts Made by New York Residents on or After April 1, 2014, Before January 1, 2019, and Within Three Years of Death in the New York Gross Estate

The Budget Legislation provides that the New York gross estate includes the value of any taxable gift (as determined for federal gift tax purposes, provided that such gift was not otherwise included in the federal gross estate), if the gift was made: (1) while the donor was a New York resident, (2) within three years of death, (3) on or after April 1, 2014, and (4) before January 1, 2019. Whether the gift is ultimately includible in the New York gross estate depends on other criteria as well. Specifically, if at the time of a decedent's death the decedent was a New York resident, the gift presumably will not be included if it consisted of real property and/or tangible property located outside of New York, although the Budget Legislation is not entirely clear on that issue. For nonresident decedents, the Budget Legislation expressly provides that any such gift is included in the decedent's New York gross estate only if the gift consisted of real property or tangible property located in New York or of intangible property of a business, trade or profession carried on in New York.

Note that there are certain problematic aspects of this piece of the Budget Legislation that may need to be addressed in future legislation, including: (1) the apportionment of estate taxes caused by inclusion of the gifts and the ability to deduct such taxes from federal estate taxes; (2) other conflicting provisions of New York estate tax laws pertaining to the estates of nonresident decedents; (3) the possibility of double taxation of the gifted property; and (4) the constitutionality of subjecting intangible business property of a nonresident decedent to New York estate tax.

¹ Because the State Basic Exclusion Amount is indexed using a different base year than the Federal Applicable Exclusion Amount, it is possible that the State Basic Exclusion Amount and the Federal Applicable Exclusion Amount may not be equal beginning in 2020.

Repeal of the New York GST Tax

Under prior legislation, New York state imposed a GST tax on taxable distributions and/or terminations from a trust to a “skip person” for GST purposes. The Budget Legislation repeals New York’s GST tax entirely.

Use of Alternate Valuation Date

The Budget Legislation provides that the New York gross estate may be valued as of the alternate valuation date (ordinarily six months after the date of death) as opposed to the date of the decedent’s death if: (1) a federal estate tax return is filed and the alternate valuation date is used, or (2) no federal estate tax return is required to be filed because the federal gross estate is below the threshold for filing a federal estate tax return. In the latter case, alternate valuation is permitted only if using the alternate valuation date will decrease the size of the decedent’s New York gross estate and thereby reduce the amount of New York estate tax due.

New York Only Qualified Terminable Interest Property (QTIP) Election

The Budget Legislation includes provisions that may be helpful to some married couples, depending on the size of each spouse’s gross estate. Specifically, the legislation provides that if an estate files a federal estate tax return and elects to qualify certain property (e.g., a marital trust) for the unlimited marital deduction from federal estate tax (a so-called “QTIP election”), the estate must make a consistent QTIP election on the New York state estate tax return. However, if the estate is not required to file a federal estate tax return because the federal gross estate is below the threshold for filing one, the estate may make an independent QTIP election on the New York state estate tax return.

Income Taxation of Exempt Resident Trusts and ING’s

Accumulated Income From Exempt Resident Trusts Subject to Income Tax When Distributed to New York Resident Beneficiaries

Under prior legislation, a resident trust’s income generally was entirely exempt from New York income tax if: (1) no trustee was domiciled in New York, (2) the trust property was located outside of New York, and (3) all trust income and gains were derived from non-New York sources. However, the Budget Legislation provides that distributions to New York resident beneficiaries of exempt resident trust income accumulated in any taxable year beginning on or after January 1, 2014 and paid after June 1, 2014 will be subject to New York income tax. Note that this part of the Budget Legislation establishes a “throwback” tax regime. That is, if an accumulation distribution to a New York resident beneficiary is made in a year subsequent to the year in which the income was earned by the trust, the distribution will be subject to New York income tax. Note that it is not clear whether this piece of the Budget Legislation would withstand scrutiny under the US Constitution were it to be challenged in the courts.

Inclusion of Current Income From ING’s in the Grantor’s Income

The Budget Legislation provides that the current net income from any ING created by a New York resident will be included in the grantor’s income. This part of the Budget Legislation is effective retroactive to January 1, 2014. However, if an existing ING is liquidated or decanted before June 1, 2014, the ING’s income will not be included in the grantor’s income at all. As with the throwback tax for exempt resident trusts discussed above, it is not clear whether this piece of the Budget Legislation would withstand scrutiny under the US Constitution were it to be challenged in the courts.

Planning Considerations

The Budget Legislation gives rise to several planning strategies that should be considered immediately. As noted below, some strategies must be implemented before June 1, 2014 if they are to be used at all.

Fund Bypass, Credit Shelter and/or Disclaimer Trusts With the State Basic Exclusion Amount

Married spouses with midsized estates—i.e., assets in excess of the State Basic Exclusion Amount but below the Federal Applicable Exclusion Amount—should consider taking full advantage of the increased State Basic Exclusion Amount by structuring their estate plans such that any so-called “bypass,” “credit shelter” or “disclaimer” trusts under their estate planning documents are funded with an amount equal to the State Basic Exclusion Amount rather than the Federal Applicable Exclusion Amount.

Balance the Assets Held by Married Spouses

Married spouses should also consider balancing and/or re-titling their assets if doing so would leave each spouse with assets at or below the State Basic Exclusion Amount and/or the Federal Applicable Exclusion Amount. Funding a specially designed marital trust referred to as a “lifetime QTIP trust” could achieve that result, while simultaneously providing the donor spouse with greater control over the assets upon the death of the donee spouse. Note that transfers to a noncitizen spouse in any year in excess of a threshold amount (\$145,000 in 2014) will constitute a taxable gift (which, if made before January 1, 2019 and within three years of death would also be included in the donor spouse’s New York gross estate). This is just one of the many tax and nontax consequences that should be considered carefully before transferring assets between spouses.

Make Charitable Bequests of Assets in Excess of the State Basic Exclusion Amount

New York residents with total assets above the State Basic Exclusion Amount should consider making charitable bequests of the assets exceeding the State Basic Exclusion Amount in order to obtain the maximum Applicable Credit Amount. Indeed, doing so could be highly beneficial even to those who are not charitably inclined. By way of illustration, if the taxable estate (before charitable bequests) of a decedent who died on April 1, 2014 equaled \$2,165,625—that is, 105% of the State Basic Exclusion Amount of \$2,062,500—and the decedent’s will provided for a charitable bequest of the difference between the taxable estate (before charitable bequests) and the State Basic Exclusion Amount (in this case \$103,125), the taxable estate would be reduced by the charitable bequest to equal the State Basic Exclusion Amount and the estate would pay no New York estate taxes. Without the charitable bequest, however, the estate would have been required to pay \$112,050 in New York estate taxes. Accordingly, by making such a charitable bequest, the decedent would be able to maximize the amount ultimately passing to the noncharitable beneficiaries, while simultaneously benefiting the charitable beneficiary.

Make Gifts of Real Property or Tangible Property Located Outside of New York

New York residents who wish to make lifetime gifts should consider gifting real property and/or tangible property located outside New York state in order to avoid having such gifts included in their New York gross estates upon their death. Note that the Budget Legislation does not expressly provide that gifts of real property and/or tangible property located outside of New York are excluded from a resident decedent’s New York gross estate. However, there is an express exception for the estates of nonresident decedents. Moreover, other laws define the New York gross estate of resident decedents to exclude real property and tangible property located outside of New York state. While the add-back period for gifts made within three years of death currently ends on December 31, 2018, there is always the possibility that the add-back period will be extended indefinitely.

Liquidate and/or Decant Existing INGs Before June 1, 2014

Trustees and/or distribution committees of existing INGs created by New York residents should consider liquidating and/or decanting such trusts before June 1, 2014 in order to avoid New York income tax on the net income from such trusts earned after January 1, 2014.

We Can Help

We hope that this advisory helps you with your New York trusts and estates planning. For more information on issues discussed in this advisory, please contact any of the attorneys listed below.

Joshua S. Rubenstein, National Head	+1.212.940.7150	joshua.rubenstein@kattenlaw.com
Ronni G. Davidowitz, New York Head	+1.212.940.7197	ronni.davidowitz@kattenlaw.com
Mal L. Barasch, Of Counsel	+1.212.940.8801	mal.barasch@kattenlaw.com
Lawrence B. Buttenwieser, Of Counsel	+1.212.940.8560	lawrence.butenwieser@kattenlaw.com
Jasmine M. Campirides Hanif, Partner	+1.212.940.6491	jasmine.hanif@kattenlaw.com
Neil V. Carbone, Partner	+1.212.940.6786	neil.carbone@kattenlaw.com
Allison S. Clayton, Associate	+1.212.940.6533	allison.clayton@kattenlaw.com
Alexandra B. Copell, Associate	+1.212.940.8588	alexandra.copell@kattenlaw.com
Lauren G. Dell, Associate	+1.212.940.6344	lauren.dell@kattenlaw.com
Marla G. Franzese, Of Counsel	+1.212.940.8865	marla.franzese@kattenlaw.com
Robert E. Friedman, Of Counsel	+1.212.940.8744	robert.friedman@kattenlaw.com
David S. Goldstein, Associate	+1.212.940.6740	david.goldstein@kattenlaw.com
Milton J. Kain, Of Counsel	+1.212.940.8750	milton.kain@kattenlaw.com
Theresa A. Kraker, Associate	+1.212.940.6678	theresa.kraker@kattenlaw.com
Dana B. Levine, Special Counsel	+1.212.940.6668	dana.levine@kattenlaw.com
Shelly Meerovitch, Partner	+1.212.940.8680	shelly.meerovitch@kattenlaw.com
Marianna Schwartzman, Associate	+1.212.940.8581	marianna.schwartzman@kattenlaw.com
Jason J. Smith, Associate	+1.212.940.6392	jason.smith@kattenlaw.com
Beth D. Tractenberg, Partner	+1.212.940.8538	beth.tractenberg@kattenlaw.com

Katten

KattenMuchinRosenman LLP www.kattenlaw.com

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