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Changes To New York Estate Tax Included In Budget Deal

As we discussed in our last letter, as part of his budget, Governor Cuomo proposed substantial changes to New York estate tax. The budget, as finalized, incorporates some of the Governor's proposals, but the original proposal was changed significantly. One of those changes contains a potentially nasty surprise for families.

The legislation does not change the basic structure of New York estate tax. The estate tax continues to follow the federal estate tax to determine what is subject to tax, how assets are valued, and what deductions are available. Although the legislation is contained in the budget, the changes—with one exception—do not depend on legislative action next year.

Changes in the Exemption against Estate Tax

The budget increases the amount exempt from New York estate tax. Over the course of three years beginning April 1, 2014, the amount exempt from New York State estate tax will increase on the following schedule:

- $2,062,500 for decedents dying between April 1, 2014 to March 31, 2015
- $3,125,000 for decedents dying between April 1, 2015 to March 31, 2016
- $4,187,500 for decedents dying between April 1, 2016 to March 31, 2017
- $5,250,000 for decedents dying between April 1, 2017 to December 31, 2018.

After December 31, 2018, the New York exemption is to be indexed for inflation. The indexing will conform the New York exemption to the federal exemption after 2019.

Nasty Surprise: Elimination of Exemption in Certain Instances

Although the New York exemption is effectively an exemption for many estates, it is also a threshold in certain instances. Some estates will not benefit from the increased New York exemption. Which estates? In short, larger estates. The New York exemption is effectively a filing threshold and a credit. Where the taxable estate exceeds 105% of the exemption, however, "no credit shall be allowed to the estate."

Nasty Surprise: Significant Reduction of Exemption in Certain Instances

Although the elimination is understandably frustrating for taxpayers, its effects are relatively straightforward. Matters get strange where a decedent's taxable estate is between 100% and 105% of the exemption. [The taxable estate is the decedent's gross estate less debts, administration expenses, amounts given to charity, and amounts given to the surviving spouse.] In that instance, the exemption is phased out. The result is tax will be due if the taxable estate is above the exemption—but not too much above the exemption.

The mechanics of the phase-out of the exemption are detailed and we will not discuss them here. Instead, we will provide an example.

Example: A decedent dies on April 2, 2014 with a taxable estate of $2,124,000, which is 3% over the applicable exemption for 2014 of $2,062,500. The amount of tax on $2,124,000 is $108,720; the exemption provides a reduction in the tax due of $31,921; so, the estate tax actually due is $76,799.

For those accustomed to thinking about marginal rates, the marginal rate on the $61,500 "excess" over the basic exclusion amount is 125%! This is somewhat misleading; however, it is not just the $61,500 that is subject to estate tax, but the entire $2,124,000.

The desirability of not exceeding the applicable exemption is clear. Given that the phase-out begins at 100% of the exemption, there is not much margin for error. There are options for reducing the taxable estate to the amount of the exemption (bequest to charity or a surviving spouse). These options should be tailored to the situation of the individual or couple; thus, a detailed discussion is not advisable without a thorough discussion of the client's circumstances and testamentary plans.

No Portability of New York Exemption

At the federal level, the exemption against the federal estate tax *not* used at the death of a spouse may be inherited by the surviving spouse under the so-called "portability provisions." The budget does *not* provide for portability of the New York exemption. If a decedent leaves all of his or her estate to a surviving spouse in a manner that qualifies for the marital deduction, the decedent's New York exemption will be lost.

Inclusion of Certain Gifts in Estates of Residents

With so much riding on the size of the taxable estate, there is an obvious incentive to reduce the size of an estate. One option is lifetime giving. New York estate tax will take into account adjusted taxable gifts made by a donor after April 1, 2014 if he or she was a New York resident at the time of the gift. The gifts that are includible gifts are those made within three years of death and before January 1, 2019.

Please note that adjusted taxable gifts do *not* include gifts to a spouse or charity, gifts that qualify for the annual exclusion against the gift tax ($14,000 per donee in 2014), and certain gifts for tuition and medical expenses.

Rate Relief

In a word, none. Unlike the exemption, the budget provides that the estate tax rates are effective only through March 31, 2015. Unfortunately, we will be revisiting the rate issue in the future.

Conclusion

A quick reading of this discussion might lead one to conclude that the changes were uniformly unfavorable. This is not so. Following the death of an individual, many beneficiaries will not have to worry about the estate bumping up against the then applicable exemption. Over time, the exemption is going in the right direction—up. Many estates that would have been subject to New York estate tax under the old provisions will not be subject to tax now. This is welcome news for many.

Where the New York estate tax will apply, however, planning will be more difficult. Without portability of the New York exemption, the question of whether to use the New York exemption at the first death of a married couple will still be present.

For an individual facing the prospect of having an estate near the exemption, the combination of the "all or nothing" feature of the New York exemption and the possible inclusion of adjusted taxable gifts in the New York gross estate will also make planning more difficult. Apart from the possibility of an estate having to pay tax, liquidity planning will be harder.

Finally, some estate plans divide an estate between a disposition to a family (or bypass) trust and a marital disposition. A Will or living trust provides a "formula clause" that defines the share passing to the family trust with reference to the amount exempt from New York tax. Thus, such formula clauses will operate to shift assets to the family trust and away from the marital disposition. Where the surviving spouse is the exclusive beneficiary of the family trust during the balance of his or her life, this might not be of concern. Where the spouse is not the exclusive beneficiary (or not a beneficiary at all), this shift may be cause for concern.

We hope that we have provided a good introduction to the changes to the New York estate tax in the latest budget. We invite you to contact a member of our Trusts and Estates Practice Area to schedule a meeting or, if you have additional questions at (585) 232-6500. □

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