New York State Changes Its Estate Tax and Creates a Need for More Detailed Planning

MetLife

Effective April 1, 2014 New York State changed its estate tax law, increasing its estate exemption from $1,000,000 to $2,062,500 per person ($4,125,000 per married couple). Under the new law, which goes into effect immediately, the New York exemption will continue to increase each year until January 1, 2019 when it will equal the inflation adjusted federal estate exemption in effect at that time.

The new law did not change New York's estate tax rates, which include a top marginal rate of 16% for taxable estates in excess of $10,040,000. Although New York continues to have an Unlimited Marital Deduction, a quirk in the new law creates a permanent "Cliff Effect". If a person's New York taxable estate exceeds the New York estate exemption by more than 5%, the exemption is phased out completely and the entire estate will be subject to New York estate tax from the first dollar.

Finally, although there is no New York State gift tax, another provision of the new law creates a "3 Year Look Back" for federal taxable gifts made during the 5 year period beginning April 1, 2014 and ending January 1, 2019. Taxable gifts subject to the 3 year look back will be included in the New York taxable estate and subject to New York estate tax. Without detailed planning it is easy to conceive how gifts subject to the 3 year look back as well as non-probate assets that pass to non-spouse beneficiaries could trigger the "Cliff Effect" and result in an unanticipated New York estate tax.

NEW EXEMPTION AMOUNT

For New York residents dying on or after April 1, 2014, the New York estate tax exemption amount will be $2,062,500. Prior to April 1, the exemption amount was $1,000,000. Each April 1, the exemption will grow as follows:

April 1, 2015:	$3,125,000 ($6,250,000 per married couple)
April 1, 2016:	$4,187,500 ($8,375,000 per married couple)
April 1, 2017:	$5,250,000 ($10,500,000 per married couple)
January 1, 2019:	Linked to the inflation adjusted federal exemption

SAME TAX RATES, SAME MARITAL DEDUCTION, BUT NO PORTABILITY

New York's estate tax rates are progressive. Tax rates start at 5.085% and increase to 16% for amounts over $10,040,000. The new law did not change the tax table. As with federal law, there is an unlimited marital deduction in New York. As a result, property inherited by a surviving spouse is estate tax free. Also, property effectively removed from New York by the surviving spouse will not be taxed in New York at the surviving spouse's death.

There is no "Portability" provision under New York law. Unlike federal law, where the surviving spouse of a married couple can claim the unused exemption of the first spouse to die, New York does not permit this. Going forward, therefore, Credit Shelter Trusts should remain very popular in New York as a way of securing the full benefit of the New York exemption of the first spouse to die. However, if a Credit Shelter Trust is funded in New York during the next 5 years using the federal exemption ($5,340,000 in 2014) which is more than 5% greater than the New York exemption ($2,065,500 as of April 1, 2014), the Cliff Effect will be triggered and the entire federal exemption will be subject to New York estate tax.

GIFTING WITH A NEW LOOK BACK PROVISION

New York does not have a state gift tax (the only state with a state gift tax is Connecticut). However, for New York estate tax purposes, the new law provides for a three year look back rule on federal taxable gifts made on or after April 1, 2014 and before January 1, 2019. This includes all federal taxable gifts made during life **EXCEPT**: (1) gifts made when the decedent wasn't a NY resident; (2) gifts made by a NY resident before April 1, 2014; (3) gifts made by a NY resident on or after January 1, 2019; and (4) gifts that are otherwise includible in the decedent's NY estate under another provision of the federal estate tax law (so that they are not taxed twice).

HOW THE TAX WORKS (The New York "Cliff")

As previously indicated, the New York estate tax will be applied in a different way than other state estate tax laws. If the value of a New York estate is below the New York exemption amount, there is no New York estate tax due. However, the New York exemption is phased out for those taxable estates that are between 100% and 105% of the exemption amount and completely phased out once the 105% is exceeded. **See the chart below**. Accordingly, if the value of the New York estate exceeds the New York exemption by an amount greater than 5%, the entire taxable estate is subject to New York estate tax.

By contrast, the exemption amount in Connecticut, for instance, may also be $2 million, but if the value of the Connecticut taxable estate is $2.5 million, then the state estate tax would apply only to the $500,000 excess amount (the amount over the exemption) – not on the entire $2,500,000.

If not taken into account, any non-probate assets passing to a non-spouse could increase the New York taxable estate and trigger the Cliff. Also, in New York, over the next 5 years, taxable gifts made under the federal exemption that exceed the New York exemption at the time of death may have the impact of locking in the Cliff and causing the entire gift to be taxed in New York under its estate tax.

Date of Death	New York Exemption (1)	Phase Out of Exemption (2)
4/1/2014 to 3/31/2015	$2,062,500	$2,165,625
4/1/2015 to 3/31/2016	$3,125,000	$3,281,250
4/1/2016 to 3/31/2017	$4,187,500	$4,396,875
4/1/2017 to 12/31/2018	$5,250,000	$5,512,500
1/1/2019 and Thereafter	Federal Exemption	Federal Exemption Plus 5%

Note: (1) No New York estate tax due (2) New York estate tax due from first dollar

FUNDING THE NEW YORK ESTATE TAX

When the New York estate exemption is fully phased-in (on January 1, 2019), New York estates that do not exceed the federal exemption will pay no Federal or New York estate tax. This will reduce the amount of state estate tax payable for the majority of New Yorkers.

Until the exemption is fully phased-in, however, life insurance owned by an irrevocable trust can be used to fund the New York estate tax by those who wish to use the maximum federal exemption at the first death. For married couples who wish to take full advantage of the New York estate exemption at the first death, given that New York does not recognize "Portability," it will be important to establish a Credit Shelter Trust at the first death.

New York estates that exceed the federal exemption by more than 5% will pay New York estate tax on the first dollar of estate value. This is because the New York exemption will be phased out. This tax may also be funded with life insurance owned by an irrevocable trust.

And finally, New Yorkers whose estates may or may not exceed the federal exemption at death have the most difficult decision because the risk of doing so by more than 5% is the complete elimination of the New York exemption and the taxation of the entire New York estate from dollar one. This also can be insured.

ACTIONS TO TAKE

The New York estate tax is not a small issue and it's important to understand its impact. However, it's more important to first establish overall legacy and financial goals. Only then can you determine what the federal and state transfer costs may be. Depending on the assets owned these costs may also include income taxes. In preparation, it is important to consider (1) overall net worth, (2) future estate value, (3) the amount of New York property owned, (4) the amount of New York gifts intended to be made in the next 5 years, (5) the provisions in the last will and testament, and (6) who the heirs are. Only then, can you plan to minimize future estate transfer costs.

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