

New York Tax Reform Relating to Estates and Trusts

On April 1, 2014, Governor Cuomo signed into law the Executive Budget for 2014-2015, which contains a number of significant modifications to the New York estate tax rules. The legislation also imposes New York income taxes on certain trust distributions of accumulated income made to New York residents.

Increase in New York Estate Tax Exemption

The legislation increases the New York estate tax exemption over the next several years from its prior level of \$1,000,000 to an amount that will match the Federal estate tax exemption beginning on January 1, 2019, as shown in the following chart.

| Increase in New York Estate Tax Exemption | |
|---|--|
| Period | Exemption |
| Prior to April 1, 2014 | \$1,000,000 |
| April 1, 2014 through March 31, 2015 | \$2,062,500 |
| April 1, 2015 through March 31, 2016 | \$3,125,000 |
| April 1, 2016 through March 31, 2017 | \$4,187,500 |
| April 1, 2017 through December 31, 2018 | \$5,250,000 |
| Beginning on January 1, 2019 | Increased to match Federal exemption (currently \$5,340,000*) |

*The Federal estate tax exemption is increased for inflation annually.

Unlike the Federal exemption, which is "portable" for married couples, any unused New York exemption of the first spouse to die will not be available for use by the surviving spouse on his or her subsequent death.

Phase Out of New York Estate Tax Exemption

Although the New York estate tax exemption is being increased substantially, the New York exemption is rapidly phased out for New York taxable estates¹ that exceed the exemption, and the benefit of the exemption is eliminated entirely for New York taxable estates that exceed the exemption by more than 5%.² Nonetheless, married couples whose combined net worth

¹ The taxable estate is, generally, that portion of an individual's estate that does not benefit from the marital or charitable deductions from estate tax.

² Under prior law, the New York exemption of \$1,000,000 was also eliminated for taxable estates in excess of the exemption.

exceeds the New York exemption can, with proper planning, still get the benefit of the New York exemption on the death of the first spouse to die through the use of a “two-share” estate plan, as described below.

Planning for Married Couples Under New Legislation

The estate plans of many married couples are designed to maximize the assets available for the use of the surviving spouse without incurring Federal estate tax on the first death and to minimize the Federal and state estate taxes payable on the survivor’s death. Many such plans divide the estate of the first spouse to die into two shares: (i) the deceased spouse’s Federal estate tax exemption, which is given to a trust for the surviving spouse and issue that will be insulated from Federal and state estate taxes at the surviving spouse’s subsequent death, and (ii) the balance of the deceased spouse’s estate, which is given to the surviving spouse outright or to a trust qualifying for the marital deduction.

A gift of the full Federal exemption on the death of the first spouse to die will result in a New York estate tax so long as the Federal exemption exceeds the New York exemption by more than 5% (which is expected to be the case until 2019, when the New York exemption is fully phased in).³ The following chart illustrates the estimated New York estate tax that would be payable on the death of the first spouse to die if, prior to 2019, the first spouse to die makes a gift of the full Federal exemption.

| New York Estate Tax on Gift of Federal Exemption* | | | | |
|--|--------------------|-------------------|---|-------------------------------|
| Date of Death | New York Exemption | Federal Exemption | Excess of Federal Over New York Exemption | New York Estate Tax on Excess |
| Prior to 4/1/2014 | \$1,000,000 | \$5,340,000 | \$4,340,000 | \$490,000 |
| 4/1/2014 | \$2,062,500 | \$5,340,000 | \$3,277,500 | \$490,000 |
| 4/1/2015 | \$3,125,000 | \$5,450,000 | \$2,325,000 | \$505,000 |
| 4/1/2016 | \$4,187,500 | \$5,560,000 | \$1,372,500 | \$520,000 |
| 4/1/2017 | \$5,250,000 | \$5,670,000 | \$ 420,000 | \$535,000 |
| 1/1/2019 | \$5,900,000 | \$5,900,000 | \$ 0 | \$ 0 |

*The Federal exemption for 2015 through 2019 is estimated based upon a projected annual increase for inflation of 2%. The calculation of the excess Federal exemption and the New York estate tax that would be imposed on such excess are, therefore, also estimated.

³ If an individual has already made lifetime taxable gifts, thereby reducing his or her Federal estate tax exemption, a gift of the remaining Federal exemption would result in a New York estate tax only if the individual’s remaining Federal exemption exceeds the New York exemption. For example, if an individual who has made taxable gifts of \$5,000,000 prior to 2014 dies in 2014, a gift of the balance of his or her remaining Federal estate tax exemption of \$340,000 would not result in the imposition of a New York estate tax.

In the earlier years, while the New York exemption is still significantly lower than the Federal exemption, for many clients it may be appropriate to pay a New York estate tax in order to make full use of the Federal exemption on the death of the first spouse to die. In particular, such a gift permits the appreciation on the full Federal exemption (rather than the smaller New York exemption) between the death of the first and second spouse to die to escape both New York and Federal estate taxes on the death of the surviving spouse. As a result, use of the full Federal exemption may result in an overall tax savings, even when the payment of the New York estate tax is taken into account.⁴ However, as the difference between the Federal and New York exemptions narrows over time, paying the New York estate tax will become less beneficial and eventually may result in an overall tax cost.

By way of example, as shown in the above table, if the first death occurs in 2014, a gift of the full Federal exemption would result in a New York estate tax of \$490,000 but would remove the appreciation on an additional \$3,277,500 from the estate of the surviving spouse. In contrast, if the first death occurs in 2017, a gift of the full Federal exemption would result in an estimated New York estate tax of \$535,000 but would remove the appreciation on only an estimated \$420,000 from the estate of the surviving spouse. Thus, in some instances, it may be appropriate to limit the estate tax exemption gift on the death of the first spouse to die to the New York exemption, thereby making use of the New York exemption, and at least a portion of the Federal exemption, without incurring a New York estate tax.

Married New York residents whose estate plans include a gift of the full Federal exemption on the death of the first spouse to die should contact us to discuss whether they wish to revise their estate plan in light of this New York tax law change.

Top Marginal New York Estate Tax Rate Remains 16%

A proposal to decrease the top marginal New York estate tax rate from 16% to 10% was not incorporated into the final legislation, and, therefore, the top marginal estate tax rate remains 16%. However, because state estate taxes are generally deductible for Federal estate tax purposes, the effective top marginal New York tax rate is 9.6% when the benefit of the Federal deduction is taken into account. The top effective combined Federal and New York estate tax rate, which applies to New York taxable estates exceeding \$10,100,000, is 49.6%.

Certain Taxable Gifts Included in New York Taxable Estate

The new legislation curtails the ability to make death bed gifts to reduce the New York taxable estate. A lifetime taxable gift⁵ made between April 1, 2014 and December 31, 2018 by an

⁴ If there is no appreciation during the life of the surviving spouse on the assets used to fund the Federal exemption gift, there would be an overall tax cost as a result of paying the New York estate tax on the first death. Thus, the life expectancy of the surviving spouse and the likelihood that the assets will appreciate in value would need to be considered to determine whether the payment of the New York estate tax on the death of the first spouse to die is appropriate.

⁵ Generally, a "taxable gift" is a gift that does not qualify for the marital deduction, the annual exclusion or the exemption for educational or medical expenses.

individual who was a New York resident at the time of the gift will be subject to New York estate tax on the donor's subsequent death if (i) the donor dies within three years after making the gift and (ii) the gift, when aggregated with the donor's New York taxable estate, exceeds the New York estate tax exemption in effect at the time of death.

Taxation of New York Resident Trust Beneficiaries

Under New York law, trusts established by New York residents ("resident trusts") are, in general, subject to New York income taxes. However, certain resident trusts, known as "exempt resident trusts", are exempted from the payment of New York income taxes. An exempt resident trust is a trust created by a New York resident that (i) does not hold any property located in New York, (ii) has no New York resident Trustees and (iii) has no New York source income. If an exempt resident trust is established in a jurisdiction, such as Delaware, that does not impose a state income tax on such a trust, only Federal income taxes are paid on trust capital gains and ordinary income accumulated in the trust.

While under the new legislation an exempt resident trust retains its income tax exempt status for New York purposes, the legislation imposes income taxes on a New York resident beneficiary of such a trust who receives a distribution of net income that was accumulated in the trust on or after January 1, 2014, with certain limited exceptions and a potential offsetting credit for taxes paid in another jurisdiction.

Despite the new legislation, there are still certain tax benefits associated with exempt resident trusts. In particular, an exempt resident trust may result in (i) the avoidance of New York income taxes on capital gains (which, in general, are taxed to the trust even if distributed to a beneficiary), (ii) the deferral of New York income taxes on income accumulated in the trust and (iii) the avoidance of New York income taxes entirely on accumulated income if the income is eventually distributed to a non-New York beneficiary.

New York Income Taxation of "ING" Trusts

The legislation eliminates for New York residents a trust technique known as an "ING" trust (an "incomplete gift, non-grantor trust"). The ING trust strategy was designed to avoid New York income taxes on a trust created by a grantor for his or her own benefit. The new legislation eliminates this technique by treating an ING trust as a "grantor trust" taxable directly to the grantor for New York income tax purposes. This change is effective as of January 1, 2014, with transitional relief available for an ING trust that is liquidated prior to June 1, 2014.

* * *

Please contact one of the attorneys in our Private Clients and Charitable Organizations Practice Group if you would like to discuss the new legislation and its potential impact on your estate plan.

Steven M. Loeb
(212) 225-2620
sloeb@cgsh.com

Judith Kassel
(212) 225-2062
jkassel@cgsh.com

Heide H. Ilgenfritz
(212) 225-2358
hilgenfritz@cgsh.com

Catherine A. Borneo
(212) 225-2292
cborneo@cgsh.com

Ruth Z. Plave
(212) 225-2094
rplave@cgsh.com

Elana S. Bronson
(212) 225-2617
ebronson@cgsh.com

Naura M. Keiser
(212) 225-2439
nkeiser@cgsh.com

Michele Leibson
(212) 225-2166
mleibson@cgsh.com

* * * *

U.S. Treasury Circular 230 Notice

Any U.S. federal tax advice included in this communication was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties.

Office Locations

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS

12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW

Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE

Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME

Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN

Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG

Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road
Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING

Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES

CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO

Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI

Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL

Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099