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REPORT OF THE TRUSTS, ESTATES AND SURROGATE'S COURTS COMMITTEE AND THE ESTATE AND GIFT TAXATION COMMITTEE

MEMORANDUM CONCERNING CERTAIN ASPECTS (i) OF THE FINAL REPORT OF THE NEW YORK STATE TAX REFORM AND FAIRNESS COMMISSION DATED NOVEMBER 2013 AND (ii) OF THE FINAL REPORT OF THE NEW YORK STATE TAX RELIEF COMMISSION DATED DECEMBER 2013

The New York City Bar Association, through its Trusts, Estates and Surrogate's Courts Committee and the Estate and Gift Taxation Committee (the "City Bar"), respectfully submits this memorandum concerning certain aspects (1) of the Final Report of the New York State Tax Reform and Fairness Commission (the "Fairness Commission") dated November 2013 (the "Fairness Commission Report") and (2) of the Final Report of the New York State Tax Relief Commission (the "Tax Relief Commission") dated December 2013 (the "Tax Relief Commission Report").[1] The Fairness Commission's recommendations (each a "Recommendation") include the following:

- To reform the New York estate tax by raising the New York estate tax exemption from $ 1 million to $ 3 million **- *we support this Recommendation, as modified by the Tax Relief Commission's Recommendation, as described below***;

- To eliminate the New York generation-skipping transfer (GST) tax, which applies to taxable distributions and taxable terminations from a trust to a "skip person" for GST tax purposes ***- we support this Recommendation***;

- To reinstate the New York gift tax, which New York repealed in 2000 - ***although we are unable to take a position because it is not the role of the New York City Bar to address the economic ramifications of taxes, we urge caution with respect to this Recommendation***; and

- To subject to New York income tax those nongrantor trusts (or New York beneficiaries of such nongrantor trusts) that are currently exempt from New York income tax under the "New York Resident Trust Exception," which applies to nongrantor trusts for which (1) all of the trustees are domiciled outside of New York State; (2) all real and tangible trust property is located outside of New York State; and

[1] We comment only on the issues addressed herein and do not take a position on other aspects of the Fairness Commission Report or the Tax Relief Commission Report. Furthermore, it is not the role of the New York City Bar to address the economics of the issues addressed herein, and we refrain from commenting at length on those issues.

(3) all trust income and gains is derived from sources outside of New York State - ***we oppose this Recommendation to the extent that it would apply to nongrantor trusts other than "DING Trusts," and observe that such legislation may raise questions under the Due Process Clause and the Commerce Clause of the U.S. Constitution.***

The Tax Relief Commission's Recommendations include the following:

- To increase the New York estate tax exemption from $ 1,000,000 to track the Federal estate tax exemption (which is $ 5,000,000, as indexed, with the indexed amount set at $ 5,340,000 for 2014) and to reduce the top New York estate tax rate from 16% to 10% ***- we support this Recommendation, to be phased in over four years, as per a press release issued by Governor Cuomo on January 6, 2014.***

Our positions on the foregoing Recommendations, together with our additional recommendations, are further discussed below.

A. We Support the Tax Relief Commission's Recommendation to Increase the New York Estate Tax Exemption from $ 1 Million to $ 5 Million, as Indexed, to Track the Federal Estate Tax Exemption Amount, and to Reduce the Top New York Estate Tax Rate from 16% to 10%, with This to Be Phased In over Four Years

The Fairness Commission recommends that the New York estate tax be based on a newly restructured rate table that is no longer tied to the federal estate tax law that was in effect on July 22, 1998, and proposes to raise the New York estate tax exemption from $1 million to $ 3 million. The Tax Relief Commission, meanwhile, goes further and recommends that the New York estate tax exemption be tied to the Federal estate tax exemption of $ 5 million subject to indexing. (The indexed Federal estate tax exemption for decedents dying in 2014 is $ 5,340,000.) In addition, the Tax Relief Commission recommends that the maximum New York estate tax rate be reduced from 16% to 10%. Pursuant to a press release issued by Governor Cuomo on January 6, 2014, the increased exemption and the decreased rates would be phased in over four years with the State estate tax exemption to equal the Federal estate tax exemption, indexed for inflation, beginning in 2019.

We support the Tax Relief Commission's Recommendation to synchronize the New York estate tax exemption with the Federal estate tax exemption, and to decrease the top New York estate tax rate from 16% to 10%, for two reasons. First, as further discussed in Section E below, we believe that a comprehensive integration of the Federal and New York estate tax systems is highly desirable. The benefits of an integrated system would include (1) allowing portability of the estate tax exemption between spouses for New York estate tax purposes (to match the corresponding federal estate tax portability rules) and (2) permitting the executor to claim a separate New York qualified terminable interest property ("QTIP") deduction on the New York estate tax return for eligible property passing in trust for the benefit of a surviving spouse *independent* of whether a QTIP election has been made on the federal estate tax return.

Second, implementing the Tax Relief Commission's Recommendation would enhance New York's competitiveness vis-à-vis other states. It is a fundamental tenet of estate planning

for wealthy New Yorkers to consider the significant estate tax savings to be achieved simply by moving to a state that does not impose a state death tax, such as Florida. This will often occur in the case of a married couple following the first spouse's death, given the availability of the estate tax marital deduction to defer federal and New York State estate taxes until the death of the surviving spouse. As succinctly stated by Governor Cuomo in his State of the State address:

> "New York[] is one of only fifteen states [with] an estate tax and our exemption levels are among the lowest and our rates are among the highest. Let's eliminate the "move to die tax" w[h]ere people literally leave our state, move to another state to do estate planning. We propose raising New York's state tax threshold and lowering the rate to put it into line with other states."[2]

We agree, and support the Tax Relief Commission's Recommendation.

B. We Support the Fairness Commission's Recommendation to Eliminate the Generation-Skipping Transfer Tax

The Fairness Commission also recommends eliminating the New York GST tax, which applies to taxable distributions and taxable terminations from a trust to a "skip person" for GST tax purposes. (This Recommendation is not addressed in the Tax Relief Commission Report.) The Fairness Commission Report notes that the GST tax "is not a major source of revenue for New York State. On average, fewer than 50 GST [tax] returns are filed and the tax generates less than $500,000 annually." Thus, repealing the GST tax would streamline New York Tax Law. We agree, and support this Recommendation.

C. We Urge Caution with Respect to the Fairness Commission's Recommendation to Reinstate the Gift Tax

The Fairness Commission further recommends reinstating the gift tax, which New York previously repealed in 2000. (The Tax Relief Commission Report did not address this issue.) At present, only two states – Connecticut and Minnesota – impose a gift tax.

As the Governor and Legislature consider the Fairness Commission's Recommendation, we suggest that they bear in mind that, because the basis rules differ for property passing by *inter vivos* gift and that passing at death, the income tax can act as a backstop to generate revenue on gifted assets not subject to the New York estate tax. Property that is gifted generally has a carryover basis for income tax purposes from the donor to the donee under IRC § 1015.[3] In contrast, where inherited property has been included in the decedent's gross estate for Federal estate tax purposes, such property will generally enjoy a "step-up" in basis to date-of-death value under IRC § 1014. New York law regarding income tax basis piggybacks on the Federal

[2] "Transcript: Governor Cuomo's 2014 State of the State Address," *available at* https://www.governor.ny.gov/press/01092014-transcript-2014-sos (visited on Jan. 15, 2014).

[3] All references to "IRC" are to the Internal Revenue Code of 1986, as amended.

provisions.[4] Since gifted property that is outside of the decedent's gross estate for estate tax purposes will not qualify for a step-up in basis under IRC § 1014 to date-of-death value, all of the inherent gain in such property will remain subject to income taxation upon sale or other taxable disposition. We question the wisdom of adding a new tax—the gift tax—on gifted assets when they already may be subject instead to an existing tax—the income tax. For this reason we flag this caution with respect to the Fairness Commission's Recommendation to reinstate the gift tax.

D. Except to the Extent That It Would Apply to "DING Trusts," We Oppose The Fairness Commission's Recommendation to Subject to New York Income Tax Those Nongrantor Trusts (or New York Beneficiaries of Such Nongrantor Trusts) That Are Currently Exempt from New York Income Tax Under the "New York Resident Trust Exception."

Finally, the Fairness Commission recommends that the exemption from New York fiduciary income tax be eliminated in the case of a New York resident trust where all of the following three conditions are met (the "New York Resident Trust Exception"):

- All trustees are domiciled outside of New York State;
- All real and tangible trust property is located outside of New York State; and
- All trust income and gain is derived from sources outside of New York State.

According to the Fairness Commission Report (at page 21), this treatment of resident trusts lends itself to a state tax planning opportunity known as a "Delaware Incomplete Gift Trust" or "DING Trust." These trusts are treated as incomplete gifts for federal gift tax purposes, and as nongrantor trusts for federal income tax purposes, so that the trust is a separate taxpayer from the grantor. Assuming that the trust's nongrantor trust status is respected by the Internal Revenue Service, the trust would not pay any New York income tax. (This issue is not addressed in the Tax Relief Commission Report.)

One option suggested by the Fairness Commission is to treat these trusts as grantor trusts for New York income tax purposes so the trust income would be included in the taxable income of the grantor. Alternatively, the Fairness Commission suggests that New York could adopt California's approach, which creates an additional modification equal to distributions to resident beneficiaries by trusts not subject to California tax. (Fairness Commission Report, at 21).

As a threshold issue for purposes of this analysis, we wish to emphasize the Federal constitutional concerns which spawned the New York Resident Trust Exception in the first place, and which continue undiminished in their vitality to this day. In *Mercantile-Safe Deposit & Trust Co. v. Murphy*, 15 N.Y.2d 579 (1964), the New York Court of Appeals invalidated New York's attempt to tax a trust created by a donor who was domiciled in New York where there was no New York resident trustee, no New York source income, and no New York situs real or tangible personal property. The continuing vitality of the U.S. constitutional analysis in

[4] *See* N.Y. Tax Law § 607.

Mercantile was recently underscored by three separate court decisions in 2013 from the courts of the State of New Jersey, the Commonwealth of Pennsylvania, and the State of Illinois respectively. These 2013 court decisions invalidated on Federal constitutional grounds ,state tax laws that sought to tax nongrantor trusts created by residents of such states where, as in *Mercantile*, there were no in-state trustees, no in-state source income, and no in-state real or tangible personal property. *See Residuary Trust A v. Director, Div. of Taxation***,** 27 N.J.Tax 68 (2013) (invalidating under the Due Process Clause of the Fourteenth Amendment to the U.S. Constitution a New Jersey statute that sought to tax a trust created under the Will of a New Jersey resident where there was no New Jersey trustee, no New Jersey assets, and notwithstanding New Jersey source income); *Robert L. McNeil, Jr. Trust v. Commonwealth of Pennsylvania*, 67 A.3d 185 (2013) (invalidating under the Commerce Clause of the U.S. Constitution a Pennsylvania statute that purported to tax a trust created by a Pennsylvania resident as to which there was no Pennsylvania trustee, no Pennsylvania assets, and no Pennsylvania source income); *Linn v. Illinois Department of Revenue*, No. 4-12-1055 (Illinois App. Ct. Dec. 18, 2013) (invalidating under the Due Process Clause of the U.S. Constitution an Illinois statute that purported to tax a trust created by an Illinois resident as to which there was no Illinois trustee, no Illinois assets and no Illinois source income).

Nevertheless, we appreciate that the position of taxpayers who have employed DING Trusts where there has not been a completed gift for federal gift tax purposes raises unique concerns as a state tax avoidance technique. It moreover would not be inconceivable for a court to determine that the absence of a completed gift for federal gift tax purposes (which could occur as a result of the New York resident's retention of an inter vivos and/or testamentary power of appointment) may establish sufficient contacts and nexus with New York State to withstand U.S Constitutional scrutiny under the Due Process Clause and the Commerce Clause. Accordingly, we believe that any proposal that attempts to limit the scope of the New York Resident Trust Exception should be expressly limited to those trusts where the donor is treated as not having made a completed gift for federal gift tax purposes.

Finally, we wish to address the method by which New York might attempt to tax DING Trusts, subject to the aforementioned constitutional concerns. The simplest approach would be for New York State to treat DING Trusts as though the New York Resident Trust Exception did not apply to them. We would, however, strongly recommend against adopting a throwback tax regime similar to that employed by California,[5] which attempts to tax on a deferred basis distributions of accumulated income that are made to California resident beneficiaries in subsequent years. The California approach is marked by great complexity, and can require the trustee to go back to trust inception to determine whether there is undistributed net income,[6] which can impose a substantial administrative burden. In contrast, treating the DING Trust as not qualifying for the New York Resident Trust Exception presents a vastly simpler solution both in trust administration and in facilitating review by the New York tax authorities.

[5] Cal. Code § 17745.

[6] *See* Cal. Code § 17745.

E. Our Additional Recommendations

(1) Allowing Portability of the Estate Tax Exemption Between Spouses for New York Estate Tax Purposes (To Match the Corresponding Federal Estate Tax Portability Rules); and

(2) Permitting the Executor to Claim A Separate New York Qualified Terminable Interest Property ("QTIP") Deduction on the New York Estate Tax Return for Eligible Property Passing in Trust for the Benefit of a Surviving Spouse *Independent* of Whether a QTIP Election Has Been Made on the Federal Estate Tax Return.

We believe that a comprehensive integration of the Federal and New York estate tax systems is highly desirable. This would include (1) allowing portability of the estate tax exemption between spouses for New York estate tax purposes (to match the corresponding federal estate tax portability rules) and (2) permitting the executor to claim a separate New York QTIP deduction on the New York estate tax return for eligible property passing in trust for the benefit of a surviving spouse *independent* of whether a QTIP election has been made on the federal estate tax return. A federal return must be filed in order to take advantage of portability for federal purposes. If an estate is below the filing threshold and a federal return is required to be filed solely for portability reasons, there would be no reason to make a federal QTIP election. There is no provision in New York, however, for making a New York QTIP election that is inconsistent with a position taken on a federal return. In TSB-M-11(9)M,[7] the guidance explicitly provides that, even if a federal estate tax return is filed solely for the purpose of electing portability, then the same QTIP election reflected on the federal return must be made for New York estate tax purposes. If a QTIP election is not made on the federal return, it cannot be made for New York purposes. This may result in a dilemma for a fiduciary who is forced to choose between a separate state QTIP election and portability. Conflicting interests might cause the fiduciary dilemma to intensify. We would be delighted to address these items in greater detail upon request.

Committee on Trusts, Estates & Surrogate's Courts
Sharon L. Klein, Chair

Committee on Estate and Gift Taxation
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[7] "Supplemental Information on New York State Estate Tax Filing Requirements Related to the Federal 2010 Tax Relief Act", NYS Dept. of Taxation and Finance Taxpayer Guidance Division, July, 29, 2011, *available at* http://www.tax.ny.gov/pdf/memos/estate_&_gift/m11_9m.pdf (visited on Jan. 17, 2014).