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

PROPOSED REFORMS TO THE NEW YORK ESTATE TAX

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 setting forth the following proposals to reform the New York estate tax ("Our Proposals," and each a "Proposal").[1]

- A Proposal to reform the New York estate tax by eliminating the "cliff" that applies to estates that are slightly above the estate tax exemption amount.
- A Proposal to reform the New York estate tax by permitting a separate state qualified terminable interest property ("QTIP") election to be made where a federal estate tax return is being filed solely to make a portability election for federal estate tax purposes or in any other situation in which the executor would not be subject to penalties under the Internal Revenue Code for failure to file a federal estate tax return.
- A Proposal to reform the New York estate tax to prevent New Yorkers who make taxable gifts subject to addback to their New York gross estate under Tax Law § 954(a)(3) from being penalized for federal estate tax purposes due to deduction limitations for state death taxes under IRC[2] § 2058 by providing that the amount of any increase in New York estate tax that is attributable to the addback of New York taxable gifts shall be subject to a reduced tax rate and apportioning such additional New York estate tax against the residuary estate (unless the governing instrument provides otherwise) through an amendment to EPTL § 2-1.8.
- A Proposal to permit a portability election for New York estate tax purposes so as to conform to the portability election for federal estate tax purposes.

Our Proposals are further discussed below.

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[1] Because it is not the role of the New York City Bar to address the economics of the issues addressed herein, we refrain from commenting at length on those issues.

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

A. We Propose to Reform the New York Estate Tax by Eliminating the "Cliff" that Applies to Estates that are Slightly Above the New York Estate Tax Exemption

The New York estate tax law provisions that came into effect on April 1, 2014 significantly increased the basic exclusion amount that is used to determine the estate's filing threshold and also to determine the amount of the applicable credit (if any).[3] In addition, a graduated tax rate table applies based on the New York taxable estate of the New York resident or nonresident decedent. For persons dying between April 1, 2014 and March 31, 2015, the top marginal estate tax rate is 16%, and applies to New York taxable estates in excess of $10,100,000. The new law does not indicate what tax rates would apply for persons dying after March 31, 2015.

In our two previous reports of January and March 2014 respectively (our "Prior 2014 Reports"), we applauded the 2014-2015 Executive Budget's efforts to enhance New York's competitiveness vis-à-vis other states by increasing the New York estate tax exemption and by proposing to decrease the New York estate tax rate from 16% to 10% (which we would continue to welcome).[4] The policy objective at issue here was succinctly stated by Governor Cuomo in his January 2014 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."[5]

The language of Tax Law § 952(c)(1), however, creates an effective "cliff" due to the rapid phase-out of the applicable credit amount for taxable estates that are only slightly in excess

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[3] The basic exclusion amount is as follows:

- $2,062,500 for decedents dying between April 1, 2014 and March 31, 2015;
- $3,125,000 for decedents dying between April 1, 2015 and March 31, 2016;
- $4,187,500 for decedents dying between April 1, 2016 and March 31, 2017;
- $5,250,000 for decedents dying between April 1, 2017 and December 31, 2018; and
- The federal basic exclusion amount for decedents dying on or after January 1, 2019.

[4] "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," Jan. 2014 *available at* http://www2.nycbar.org/pdf/report/uploads/20072643-MemoonAspectsofNYSTaxReliefCommissionReport.pdf; "Memorandum concerning certain aspects of the 2014-2015 New York State Executive Budget dated January 20, 2014," March 2014, *available at* http://www2.nycbar.org/pdf/report/uploads/20072670-Memoon2014-2015StateBudget.pdf.

[5] "Transcript: Governor Cuomo's 2014 State of the State Address," *available at* https://www.governor.ny.gov/press/01092014-transcript-2014-sos.

of the basic exclusion amount that is inconsistent with this policy objective of eliminating incentives for wealthy New Yorkers to move to another state to avoid the New York estate tax. Tax Law § 952(c)(1) provides (emphasis added):

> A credit of the applicable credit amount shall be allowed against the tax imposed by this section as provided in this subsection. In the case of a decedent whose New York taxable estate is less than or equal to the basic exclusion amount, the applicable credit amount shall be the amount of tax that would be due under subsection (b) of this section on such decedent's New York taxable estate. In the case of a decedent whose New York taxable estate exceeds the basic exclusion amount by an amount that is less than or equal to five percent of such amount, the applicable credit amount shall be the amount of tax that would be due under subsection (b) of this section if the amount on which the tax is to be computed were equal to the basic exclusion amount multiplied by one minus a fraction, the numerator of which is the decedent's New York taxable estate minus the basic exclusion amount, and the denominator of which is five percent of the basic exclusion amount. Provided, however, that the credit allowed by this subsection shall not exceed the tax imposed by this section, **and no credit shall be allowed to the estate of any decedent whose New York taxable estate exceeds one hundred five percent of the basic exclusion amount.**

As indicated above, Tax Law § 952(c)(1) provides an extremely steep slope that phases out the applicable credit amount for New York taxable estates that are between 100% and 105% of the basic exclusion amount, and eliminates the basic exclusion amount altogether for the estate of any decedent whose New York taxable estate exceeds one hundred and five percent of the basic exclusion amount. Assuming a basic exclusion amount of $5,250,000 (which applies for decedents dying between April 1, 2017 and December 31, 2018), a decedent with a New York taxable estate of $5,512,500 (which is 105% of the basic exclusion amount of $5,250,000) would pay New York estate tax of $ 430,050. In effect, there is a New York estate tax of $430,050 (or a marginal New York estate tax rate of nearly 164%) on the additional New York taxable estate of $262,500 in excess of the basic exclusion amount of $5,250,000.

The effect of this cliff is also demonstrated in recent guidance issued by the New York State Department of Taxation and Finance (the "New York Tax Department") on August 25, 2014 in TSB-M-14(6)M (the "Tax Department's Estate Tax Guidance"). The Tax Department's Estate Tax Guidance provides an example where an individual dies with a taxable estate of $2,100,000, which is $37,500 above the basic exclusion amount of $2,062,500 for persons dying between April 1, 2014 through March 31, 2015. This produces a New York estate tax of $49,308, which computes to a marginal estate tax rate of more than 131% on the amount of the taxable estate in excess of the basic exclusion amount ($49,308 / $37,500 = 1.3149, which rounds to more than 131%). (This marginal estate tax rate gets even higher in subsequent years due to the mathematics involved as the basic exclusion amount increases from year to year,

traversing into higher marginal tax rates that would otherwise be soaked up by the applicable credit amount.)

We do not believe that this cliff is consistent with the Governor's objectives, as set forth in his "State of the State Address" in January 2014, of making New York a more favorable environment for senior New Yorkers. Accordingly, we suggest that this cliff be eliminated altogether by removing both the phase-out and the elimination of the applicable credit amount.

If, however, the need for revenue is such that New York State is unable to "eliminate" the cliff, our alternate proposal is that the Legislature lessen the burden by reducing the effect of the cliff. One way of doing this would be to reduce the benefit of the credit on a very gradual basis – *i.e.*, to effectively "extend the runway" over which the applicable credit amount is phased out, such as between 100% and 150% of the basic exclusion amount (instead of between 100% and 105% of the basic exclusion amount as the law currently provides).

B. We Propose to Reform the New York Estate Tax by Permitting a Separate State Qualified Terminable Interest Property ("QTIP") Election to be made in circumstances where a Federal Estate Tax Return is Filed to Elect Portability of the Deceased Spouse's Unused Exclusion Amount

We also propose to reform the New York estate tax law by permitting a separate state QTIP election to be made when a federal estate tax return is being filed solely to elect portability of the deceased spouse's unused exclusion amount.

Tax Law § 955(c) provides that the qualified terminable interest property ("QTIP") election will not be allowed for New York State estate tax purposes unless such election was made with respect to a federal estate tax return that was required to be filed. If such election is made for federal estate tax purposes, then such election must also be made for New York estate tax purposes. *However, where no federal estate tax return is required to be filed, a New York QTIP election is permitted.*[6]

This statutory language contains an apparent ambiguity which manifests itself where a federal estate tax return is being filed solely for purposes of electing portability of the deceased spousal unused exclusion amount under IRC § 2010(c) and the federal estate tax return is not otherwise required to be filed. The Tax Department's Estate Tax Guidance provides that a federal estate tax return is considered "required to be filed" when a deceased individual's gross estate exceeds the federal filing threshold ***or*** when the filing of the federal estate tax return is the only means for claiming certain tax treatment, such as claiming portability of the deceased spouse unused exclusion amount for federal estate tax purposes. This last point impresses us as highly problematic, because although a federal estate tax return is indeed required to be filed in order to make a portability election under IRC § 2010(c), the executor of an estate below the threshold for having to file a federal estate tax return would not be subject to any penalties under the Internal Revenue Code if he or she simply chose not to file a federal estate tax return to make a portability election, or otherwise inadvertently failed to do so.

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[6] *See* N.Y. Tax Law § 955(c).

This is not merely an academic point. The inability of a fiduciary to make a separate state QTIP election may result in a dilemma for a fiduciary who is forced to choose between a separate state QTIP election and portability. Conflicting interests among beneficiaries (such as where there are children of a prior marriage who do not get along with the surviving spouse) might cause the fiduciary dilemma to intensify.

Accordingly, we propose that New York law be amended to provide that the filing of a federal estate tax return that would not subject the executor to any penalties under the Internal Revenue Code had it not been timely filed shall ***not*** be considered a return that is required to be filed so as to preclude the making of a separate state QTIP election.

C. We Propose to Reform the New York Estate Tax to Prevent New Yorkers Who Make Taxable Gifts Subject to Addback to their New York Gross Estate from being Penalized for Federal Estate Tax Purposes Due to Deduction Limitations

Tax Law § 954(a)(3) establishes an "addback" for taxable gifts that New Yorkers make after March 31, 2014 while a resident of New York State during the three-year period immediately preceding their death and prior to January 1, 2019.[7] The Tax Department's Estate Tax Guidance recently clarified that this addback does not apply to post-March 31, 2014 gifts of real and tangible property located outside of New York State.[8]

It is questionable whether this addback component for certain lifetime taxable gifts would be deductible for federal estate tax purposes under IRC § 2058, which applies to state death taxes. To be deductible under IRC § 2058, the state death tax must be paid "in respect of any property included in the gross estate . . . ." Tax Law § 954(a)(3), however, only applies if the taxable gift is not otherwise included in the decedent's federal gross estate. If this interpretation of the Internal Revenue Code is correct, then the effect of this gift-addback provision is to make New York even more uncompetitive than it currently is compared to other states and increase, rather than decrease, the incentive for the very wealthy to emigrate.

One approach to address this would be to reduce the rate of New York estate tax imposed on the portion of the New York gross estate that is not part of the federal gross estate — that is, the taxable gift addback – to what the net cost would have been if the tax had been deductible. Under current rates that is generally a reduction of 40% of the New York marginal estate tax rate otherwise applicable, although as a drafting matter to accommodate future rate changes it would be advisable for any such legislation to describe the desired result by a non-mathematical formula.[9]

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[7] *See* N.Y. Tax Law § 954(a)(3).

[8] *See* TSB-M-14(6)M (Aug. 25, 2014).

[9] Another approach could be to amend Section 13-1.3 of the New York Estates, Powers and Trusts Law to statutorily treat the New York estate tax attributable to the taxable gift addback as a debt allocable to the residuary estate, except as may be otherwise provided in the deed of gift, Will or other governing instrument. This statutory treatment of the addback as a debt presumably should be respected for federal estate tax purposes. *See Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

In addition, there is an estate tax apportionment issue relating to the New York estate tax that is attributable to the inclusion of such New York adjusted taxable gifts – *to wit, who should bear the tax – the probate estate or the recipient of the lifetime gift?* We suggest that EPTL § 2-1.8 should be amended to specially allocate this portion of the tax to the residuary estate (unless the governing instrument provides otherwise) along the lines of the special provisions already there for qualified terminable interest property and certain other property.

D. We Propose to Reform the New York Estate Tax to Allow Portability of the Applicable Exclusion Amount Between Spouses for New York Estate Tax Purposes (To Match the Corresponding Federal Estate Tax Portability Rules)

As we previously suggested in our Prior 2014 Reports, in order to better integrate the federal and New York State estate tax systems, we recommend that portability of the estate tax exemption between spouses be allowed for New York estate tax purposes, to match the corresponding federal estate tax portability rules that are set forth in IRC § 2010(c).[10] Portability of the deceased spouse's *entire* unused exclusion amount for New York estate tax purposes (as opposed to partial portability) is necessary to avoid creating a significant federal/state mismatch that would undermine the objective of attaining a comprehensive integration of the federal and New York estate tax systems.

We have set forth below a proposed New York portability statute, which would be included as part of Tax Law § 952(c). The added language relating to portability appears in underlined italics.

> (c) Applicable credit amount. (1) A credit of the applicable credit amount shall be allowed against the tax imposed by this section as provided in this subsection. In the case of a decedent whose New York taxable estate is less than or equal to the basic exclusion amount, the applicable credit amount shall be the amount of tax that would be due under subsection (b) of this section on such decedent's New York taxable estate. In the case of a decedent whose New York taxable estate exceeds the basic exclusion amount by an amount that is less than or equal to five percent of such amount, the applicable credit amount shall be the amount of tax that would be due under subsection (b) of this section if the amount on which the tax is to be computed were equal to the basic exclusion amount multiplied by one minus a fraction, the numerator of which is the decedent's New York taxable estate minus the basic exclusion amount, and the denominator of which is

[10] A related component to better integrate the federal and New York State estate tax systems for a married couple involves 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. The separate QTIP deduction on the New York estate tax return has already been addressed by us in Item B of this Report.

five percent of the basic exclusion amount. Provided, however, that the credit allowed by this subsection shall not exceed the tax imposed by this section, and no credit shall be allowed to the estate of any decedent whose New York taxable estate exceeds one hundred five percent of the basic exclusion amount. *Provided, further, that the credit allowed by this subsection shall be increased by an amount equal to the unused applicable credit amount of the decedent's last deceased spouse.*

(2) For purposes of this subsection, unused applicable credit amount of the decedent's last deceased spouse is (i) the amount of the credit that would have been allowed under subdivision (1) on the New York taxable estate of the last deceased spouse if that spouse's New York taxable estate had been equal to the basic exclusion amount allowable at the date of death of the decedent's last deceased spouse reduced by (ii) the amount of the credit allowed the estate of the decedent's last deceased spouse. Provided, however, that no credit amount of the decedent's last deceased spouse shall be allowed if the New York taxable estate of the decedent's last deceased spouse was equal to or greater than the basic exclusion amount allowable at the date of death of such last deceased spouse. The credit amount of the decedent's last deceased spouse, as referenced in the immediately preceding sentence of this subsection, shall take into account such adjustments as may be warranted pursuant to Tax Law § 952(c)(1).

The New York State Department of Taxation of Finance, presumably through the issuance of a Technical Services Memorandum, would be charged with the responsibility of determining "such adjustments as may be warranted pursuant to Tax Law § 952(c)(1)" in accordance with the language appearing in the last sentence of our proposed Tax Law § 952(c)(2), as set forth above.[11]

Committee on Trusts, Estates & Surrogate's Courts
John M. Olivieri, Chair

Committee on Estate and Gift Taxation
Paul A. Ferrara, Chair

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[11] As set forth in Item A of this Report, we recommend that the "cliff" aspects of proposed Tax Law § 952(c)(1) be eliminated in their entirety. Eliminating this estate tax cliff would render unnecessary the last two sentences of proposed Tax Law § 952(c)(2).