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REPORT OF THE ESTATE AND GIFT TAXATION COMMITTEE AND THE TRUSTS, ESTATES AND SURROGATE'S COURTS COMMITTEE SETTING FORTH PROPOSALS TO REFORM THE NEW YORK STATE ESTATE TAX

The New York City Bar Association, through its Estate and Gift Taxation Committee and its Trusts, Estates and Surrogate's Courts Committee (the "City Bar"), respectfully submits this memorandum setting forth its proposals to reform the New York State estate tax (the "Proposals"), and provides proposed statutory language to implement them. The following Proposals are addressed in this memorandum:

1. A Proposal to smooth the estate tax cliff under N.Y. Tax Law § 952(c)(1) by effectively "extending the runway" over which the applicable credit amount is phased out 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);

2. A Proposal to prevent the inequitable treatment of certain New York taxable estates where the "addback" of New York taxable gifts under N.Y. Tax Law § 954(a)(3) penalizes the estate for federal estate tax purposes, by providing that the amount of any increase in New York estate tax that is attributable to such addback shall be treated as a debt of the decedent that has come into existence immediately prior to the decedent's death pursuant to Section 13-1.3 of the New York Estates, Powers and Trusts Law (the "EPTL") (unless the governing instrument provides otherwise); and

3. A Proposal to permit 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 of 1986, as amended (the "IRC") for failure to file a federal estate tax return.

I. "EXTENDING THE RUNWAY" TO SMOOTH OUT THE NEW YORK ESTATE TAX CLIFF

The estate tax "cliff" contained in N.Y. Tax Law § 952(c)(1) results from the rapid phase-out of the applicable credit amount for taxable estates that are only slightly in excess of the basic exclusion amount for New York estate tax purposes.[1] The current cliff has the effect of

[1] The basic exclusion amount is as follows:

producing a marginal New York estate tax rate substantially in excess of 100% until a complete phase-out of the applicable credit amount has been achieved. Although the neighboring states of Connecticut and Rhode Island have both recently eliminated the cliff provisions of their respective estate tax statutes, we understand that New York State's need for revenues is such that the complete elimination of the New York estate tax cliff may not be feasible at this time.

The statute at issue here is N.Y. Tax Law § 952(c)(1), which provides as follows (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, N.Y. 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 105% of the basic exclusion amount.[2] We believe that this cliff should be smoothed by "extending the runway" over which

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- $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.

[2] The effect of this cliff is 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 amount is $37,500 above the basic exclusion amount of $2,062,500 for persons dying between April 1, 2014 and March 31, 2015. This estate is subject to a New York estate tax of

the applicable credit amount is phased out from 5% above the basic exclusion amount (as the law currently provides) to 50% above the basic exclusion amount. As so amended, N.Y. Tax Law § 952(c)(1) would read as follows (with the new language underlined and in bold):

> 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 **fifty 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 **fifty 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 **fifty percent** of the basic exclusion amount.

II. PREVENTING THE ESTATES OF NEW YORK DECEDENTS WHO MADE TAXABLE GIFTS SUBJECT TO ADDBACK FROM BEING PENALIZED FOR FEDERAL ESTATE TAX PURPOSES DUE TO DEDUCTION LIMITATIONS UNDER FEDERAL ESTATE TAX LAW

As discussed in our prior reports,[3] N.Y. Tax Law § 954(a)(3)[4] establishes an "addback" for certain taxable gifts that a New York decedent made after March 31, 2014 and during the

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$49,308, which computes to a marginal estate tax rate of approximately 131% on the amount of the taxable estate in excess of the basic exclusion amount ($49,308 / $37,500 = 1.3149). (This marginal estate tax rate will increase further in any subsequent year in which the basic exclusion amount increases.)

[3] *Available a*t http://www2.nycbar.org/Publications/reports/reportsbycom.php?com=51.

[4] N.Y. Tax Law § 954(a) provides as follows:

(a) General.--The New York gross estate of a deceased resident means his or her federal gross estate as defined in the internal revenue code (whether or not a federal estate tax return is required to be filed) modified as follows:

(1) Reduced by the value of real or tangible personal property having an actual situs outside New York state.

(2) Increased by the amount determined under section nine hundred fifty-seven of this part (relating to limited powers of appointment created prior to September first, nineteen hundred thirty).

(3) Increased by the amount of any taxable gift under section 2503 of the internal revenue code not otherwise included in the decedent's federal gross estate, made during the three year period ending on the decedent's date of death, but not including any gift made: (A) when the decedent was not a resident of New York state; or (B) before

three-year period immediately preceding such decedent's death. This addback applies to individuals who die prior to January 1, 2019.[5] 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,[6] and this clarification was codified on April 1, 2015.

It is questionable whether the addback 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...." N.Y. Tax Law § 954(a)(3), however, only applies if the taxable gift is not otherwise included in the decedent's federal gross estate. Therefore, the addback provision may subject the property added back to the full maximum 16% New York estate tax rate, without any offsetting federal estate tax deduction.

One approach to address this issue would be to amend N.Y. Tax Law § 954(a)(3) to treat the New York estate tax attributable to the addback amount as a debt of the decedent that came into existence immediately prior to the decedent's death, subject in all respects to Section 13-1.3 of the EPTL (except as otherwise provided in the decedent's deed of gift, Will or other governing instrument).[7] As a result of this treatment as a debt, the estate tax apportionment provisions set forth in EPTL § 2-1.8 would not apply to the estate tax attributable to the taxable gift addback. The statutory treatment of the addback as a debt should be respected for federal estate tax purposes. *See Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

The foregoing objective could be accomplished by amending N.Y. Tax Law § 954(a)(3) to add the following two concluding sentences to N.Y. Tax Law § 954(a)(3):

> Except as may otherwise be provided in the deed of gift, Will or other governing instrument by specific reference to the addition to the New York gross estate attributable to this subsection (a)(3), any addition to the New York estate tax attributable to this subsection (a)(3) (the "Transfer Tax Debt Amount") shall be treated as a debt of the decedent (a) that came into existence immediately prior to the decedent's death, (b) that is subject in all respects to § 13-1.3 of the New York Estates, Powers and Trusts Law, and (c) that shall not be subject to apportionment under § 2-

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April first, two thousand fourteen; or (C) that is real or tangible personal property having an actual situs outside New York state at the time the gift was made. Provided, however that this paragraph shall not apply to the estate of a decedent dying on or after January first, two thousand nineteen.

[5] *See* N.Y. Tax Law § 954(a)(3).

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

[7] Another approach to address this issue would be to reduce the rate of New York estate tax imposed on the addback to what the net cost would have been if the tax had been deductible. Under current rates, that reduction is approximately 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.

> 1.8 of the New York Estates, Powers and Trusts Law. Except as may otherwise be provided in the deed of gift, Will or other governing instrument by specific reference to the addition to the New York gross estate attributable to this subsection (a)(3), the Transfer Tax Debt Amount shall equal the amount by which the total tax imposed under this article exceeds the total tax that would have been imposed under this article if this subsection (a)(3) did not apply.

III. PERMITTING A SEPARATE STATE QUALIFIED TERMINABLE INTEREST PROPERTY ("QTIP") ELECTION TO BE MADE IN CIRCUMSTANCES WHERE A FEDERAL ESTATE TAX RETURN IS ONLY FILED TO ELECT PORTABILITY OF A DECEASED SPOUSE'S UNUSED EXCLUSION AMOUNT 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

As set forth in our previous reports, we 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 for a deceased spouse's unused exclusion amount (the "DSUE") under IRC § 2010(c) or in any other situation in which the executor would not be subject to penalties under the IRC for failure to file a federal estate tax return.

N.Y. Tax Law § 955(c) provides that a qualified terminable interest property ("QTIP") election will not be allowed for New York State estate tax purposes unless (a) such election is made for federal purposes on a federal estate tax return that is required to be filed, or (b) no federal estate tax return is 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 filing the federal estate tax return is the only means for claiming certain tax treatment, such as portability for a deceased spouse's DSUE for federal estate tax purposes. Unfortunately, the New York statute does not consider what happens when a decedent's estate does not meet the threshold requiring the filing of a federal estate tax return, and no federal QTIP election is made, although a federal estate tax return is in fact filed for purposes of electing portability for the deceased spouse's DSUE and/or to make certain elections or allocations of exemption for generation-skipping transfer tax purposes.

This ambiguity in the New York law can have significant consequences in estate administration. The inability of a fiduciary to make a separate state QTIP election may result in a dilemma for an executor 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 executor's dilemma to intensify.

Accordingly, we propose that N.Y. Tax Law § 955(c) be amended to incorporate the provisions in the Senate's 2014 proposed bill S.6359-C with the revisions set forth below (as

modified in this Proposal), to allow a separate state QTIP election to be made with respect to any federal estate tax return that is filed solely for the purpose of electing a surviving spouse's DSUE or in any other situation in which the executor would not be subject to penalties under the IRC for failure to file a federal estate tax return.

> (c) Qualified Terminable Interest Property Election. – Except as otherwise provided in this subsection, the election referred to in paragraph (7) of subsection (b) of section 2056 of the internal revenue code shall not be allowed under this article unless such election was made with respect to the federal estate tax return required to be filed under the provisions of section 6018 of the internal revenue code. If such election was made on a federal estate tax return required to be filed under the provisions of section 6018 of the internal revenue code ~~for the purposes of the federal estate tax~~, then such election must also be made by the executor on the return of the tax imposed by this article. Notwithstanding the foregoing, where no federal estate tax return is required to be filed under the provisions of section 6018 of the internal revenue code, and a federal estate tax return is filed to elect the deceased spousal unused exclusion amount under paragraphs (4) and (5) of subsection (c) of section 2010 of the internal revenue code, or for any other purpose, the executor may make the election referred to in such paragraph (7) with respect to the tax imposed by this article on the return of the tax imposed by this article. Any election made under this subsection shall be irrevocable.

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