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REPORT ON LEGISLATION BY THE ESTATE AND GIFT TAXATION COMMITTEE

A.3226 **M. of A. Dinowitz**
S.6080 **Sen. Hoylman**

AN ACT to amend the estates, powers and trusts law, in relation to providing a presumption that credit shelter bequests be construed to set aside the maximum amount that may be shielded from both federal and state estate taxes

THIS BILL IS APPROVED

The New York City Bar Association, through its Estate and Gift Taxation Committee (the "Committee"), supports this proposed legislation that would add a new section to the Estates, Powers and Trusts Law (the "EPTL") as Section 2-1.12-a. This legislation, if enacted, would govern the interpretation of credit shelter bequests in testamentary documents in order to avoid unintended consequences caused by changes to New York tax law. Specifically, the statute would provide a presumption that credit shelter bequests be construed to set aside the maximum amount that may be shielded from both federal and New York state estate taxes.

I. BACKGROUND

New York State taxes estates at different amounts and different rates than the federal government. Currently, New York's estate tax exemption (also known as the basic exclusion amount) is less than the $11,400,000 federal estate tax exemption. Section 952(c)(1) of the New York Tax Law (the "NYTL"), enacted in 2014, was designed to raise the New York estate tax exemption amount periodically over the next several years, eventually eliminating the disparity between it and the federal exemption. Specifically, the law increased the state's exemption amount from $2,062,500 (in 2014) to $5,740,000 (in 2019), with annual inflationary adjustments to be made in subsequent years. However, the federal 2017 Tax Act doubled the federal estate tax exemption as of January 1, 2018, and for 2019 the federal exemption is $11,400,000, with annual inflationary adjustments to be made in subsequent years through 2025, after which the Act will sunset and the federal exemption will revert to its pre-2018 level as adjusted for inflation. Absent a significant increase in the New York estate tax exemption (or until the sunset of the federal 2017 Tax Act), the New York estate tax exemption will remain substantially less than the federal exemption.

Under NYTL Section 952(c)(1), individuals with taxable estates less than or equal to the New York State basic exclusion amount will pay no state estate tax. However, the New York

exemption is phased out rapidly for estates valued between 100% and 105% of the basic exclusion amount, with individuals whose taxable estates exceed 105% of the basic exclusion amount effectively taxed on the entire estate.

At the federal level, it has been common for married testators to take advantage of the federal estate tax exemption by including dispositions in their testamentary documents intended to transfer the remaining federal exemption to individuals other than the surviving spouse or to trusts for the surviving spouse and descendants without intending to trigger any estate tax upon the first spouse's death. These bequests are typically drafted with a formula designed to capture the full federal exemption amount effective and available at the time of the first spouse's death. Such "credit shelter bequests" remain prevalent in estate planning documents despite the introduction of portability at the federal level by which the second spouse to die may use the predeceased spouse's remaining federal exemption. Indeed, many testators still include these bequests in order to utilize any remaining generation-skipping transfer tax exemption, provide creditor protection, direct the ultimate disposition of the devised property or capture the appreciation on such property free of federal estate tax.

Unfortunately, recent changes to the NYTL may create unintended consequences for decedents whose estate plans have not been updated. The inclusion of a credit shelter bequest now often triggers a state-level tax that exceeds both the effective tax rate under portability as well as, in some cases, the difference between the state and federal exemption amounts. The Committee believes that the addition of EPTL 2-1.12-a will solve this issue.

II. DISCUSSION

a. Recent Changes to New York Tax Law Have Created Unintended Consequences for Certain Decedents Whose Estate Plans Include Formula Bequests of the Federal Exemption Amount.

As a result of the federal 2017 Tax Act and the recent changes to NYTL Section 952(c)(1), the federal exemption amount will continue to exceed the New York exemption amount through 2025. Coupled with dramatic phase-outs of the state exemption for estates exceeding 105% of the applicable state exemption amount, this system inadvertently leads to a very substantial state estate tax for decedents whose testamentary plans include a marital disposition of the full federal exemption amount.

For example, the New York exemption is $5,740,000 for decedents who die between January 1, 2019 and December 31, 2019. Assuming the current federal exemption amount, an individual whose testamentary plan includes a standard credit shelter bequest fully funded with the federal exemption amount would set aside $11,400,000; yet, the resulting New York tax would be almost $1,300,000 (meaning that $1,300,000 in New York State estate tax would be required to shelter the excess by which the federal exemption exceeds the New York State exemption, or $5,660,000, an effective tax rate of almost 23% on an estate otherwise exempt from federal estate tax). Improbably, the punitive effect becomes more acute as the size of the credit shelter bequest decreases. Thus, a credit shelter bequest of $6,027,000 (105% of the state's exemption), an amount fully sheltered by the federal exemption—and only $287,000

above the New York exemption—would trigger state estate tax in excess of $510,000, an effective tax rate of over 177%!

For decedents dying between 2019 and 2025, the effective state-level tax is so high that it is unlikely that an individual would ever intentionally set aside the full federal exemption amount, particularly when portability is an option. However, because many testators' estate planning documents have not been (and may not be) revised to account for the recent change to NYTL Section 952(c)(1), a significant number of New York estates may be subject to this unintended consequence.

b. New York Has a Strong History of Permitting Reformation of Testamentary Documents to Avoid Unanticipated Tax Effects.

There is rich history in the New York courts of reforming testamentary documents to avoid unintended adverse tax consequences. Specifically, the courts have demonstrated a robust policy of permitting reformation to take full advantage of available tax deductions and exemptions where there has been a change in the tax law.[1] Indeed, the presumption that testators intend to minimize taxes has been applied consistently by the courts to secure specific tax advantages through reformation where the intent of the testator is apparent.[2]

To avoid an influx of reformation actions in the courts, the state legislature has enacted remedial legislation to address unexpected consequences arising from changes in tax law. For example, in 2000, in light of the elimination of the state death tax credit, the legislature enacted EPTL Section 2-1.12. Under this EPTL Section, certain testamentary documents executed prior to February 1, 2000 containing formula bequests which reference the credit for state death taxes are construed without regard to the reference. Further, in response to the 2010 repeal of the federal estate tax and the generation-skipping transfer tax, the legislature enacted EPTL Section 2-1.13 to require interpretation of certain formula bequests as if they were made pursuant to the Internal Revenue Code provisions in effect prior to the repeal. The enactment of the federal 2017 Tax Act warrants a similar response by the state legislature to avoid the unintended consequence of subjecting what could be an otherwise nontaxable estate of a married decedent to confiscatory state estate tax.

III. RECOMMENDATION

The Committee supports the proposed legislation, which recommends that the EPTL be modified to incorporate the proposed Section 2-1.12-a described above in order to remedy the

[1] *See, e.g.,* Matter of Choate, 141 Misc.2d 489 (Sur. Ct. 1988).

[2] For instance, in the past, New York courts have (i) reformed trusts in order to qualify them for the charitable deduction under the new requirements for charitable remainder trusts after the 1969 Tax Reform Act; (ii) permitted reformation of provisions in wills to permit taking advantage of the later enacted unlimited marital deduction; and (iii) construed tax apportionment clauses in wills where literal application of the provisions would frustrate the testator's intention. *See, e.g.*, Matter of Gottfried, NYLJ, April 11, 1997 (Sur. Ct. 1997); Matter of Martin, 146 Misc. 2d 144 (Sur. Ct. 1989); Matter of Choate, 141 Misc.2d 489 (Sur. Ct. 1988); Matter of Lepore, 128 Misc. 2d 250 (Sur. Ct. 1985).

effects of NYTL Section 952(c)(1) on decedents whose testamentary documents include credit shelter bequests or other dispositions of the federal exemption amount.

Estate and Gift Taxation Committee
Evelyn M. Capassakis, Chair

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