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Proposed Changes to New York Estate Tax and Trust Income Tax Law

Governor Cuomo's Executive Budget Bill for 2014 – 2015 (the "Bill") includes important proposed changes to New York's taxation of estates and trust beneficiaries. The Bill contains many favorable estate tax provisions, such as an increase in the New York estate tax exemption and a reduction in the top estate tax rate, with both changes to be implemented over the next four years.

Unfortunately, the Bill also contains a less favorable proposal that effectively would act as a deferred State gift tax, payable at death. Under the proposed new law, the estate of a New York resident decedent (or a non-resident with New York property) would be increased by certain taxable gifts made by him or her on or after April 1, 2014, thereby enhancing the State estate tax.

Estate Tax Inclusion of Lifetime Gifts

Under current law, New York has an estate tax, but not a gift tax. Consequently, New York residents may make gifts without New York gift tax, thereby reducing the amount of their estate ultimately subject to New York estate tax. By employing this strategy, New York residents may be able to obtain a net transfer tax savings equal to approximately 9.6% of the value of the lifetime gifts. Proposed changes to New York law would eliminate this strategy for lifetime gifts made after March 31, 2014.

This proposal is intended to deal with a specific perceived abuse. Some New York residents were making large gifts in anticipation of death to avoid New York estate tax. Given the stated purpose of the Bill, it has been suggested that the proposal should be limited in its application to gifts made within one year of death. It is not clear whether New York State will embrace that modification.

It is important to bear in mind that the Bill is only a proposal. It is not certain, at this time, that the proposed changes will be enacted, and if enacted, we cannot be sure of the final terms of the legislation. Nevertheless, for clients otherwise inclined to make gifts in the near term, this development may provide the appropriate incentive to accelerate the gifts.

Increased Estate Tax Exemption and Rate Reduction

Under the proposed new law, New York State's estate tax exemption will be increased over a four-year period, from $1 million to $5 million (with an adjustment for inflation to match the Federal exemption). However, the exemption is eliminated completely for high net worth taxpayers. The Bill reduces the exemption to zero for any estate with a value in excess of 105% of the then State exemption. This anomaly has been criticized and it remains to be seen if New York State will modify the provision.

In addition, over the next four years, the top State estate tax rate will be reduced from 16% to 10%.

Tax on New York Beneficiaries

Under the Bill, in very general terms, a tax would be imposed on distributions of accumulated trust income to New York beneficiaries from trusts which themselves do not pay current New York State income tax. This proposal, if enacted, would make New York State only the second state (after California) to have a so-called throwback tax. The proposal has been criticized due to its complexity, technical flaws and policy considerations. At this point, it is unclear if the proposal will gain traction in the legislature.

Additional Tax Law Changes

The Bill also repeals the New York generation-skipping transfer, or GST, tax that otherwise would apply to certain trust distributions. Under current law, New York's GST tax applies in limited circumstances, when distributions are made to beneficiaries who are two or more generations below the trust's grantor, if the distribution occurs as a result of an individual's death. This change, if enacted, will not affect the need to plan properly with generation-skipping transfers, as the Federal GST tax will remain in place.

New York is seeking to tax income of certain trusts, commonly referred to as "ING" Trusts (an acronym for Incomplete Non-Grantor Trusts). These trusts are designed to escape State income tax, but without triggering a gift tax when funded. (The trust assets do not escape State estate tax; the strategy is aimed solely at reducing State income tax.) To address this perceived abuse, the Bill would treat the grantor as the owner of the underlying assets, thereby exposing a New York grantor to State income tax on the trust income.

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