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## New York Adopts Major Changes to Estate and Trust Taxation

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**On April 1, 2014, New York State enacted a new budget (the “Budget Legislation”), which includes legislation that makes significant changes to New York tax law. Included in the Budget Legislation are reforms that will more closely align New York’s estate tax exclusion with the federal exclusion, include some lifetime gifts in the taxable estates of New York decedents and subject the income of certain trusts to New York tax for the first time. New York taxpayers should be aware of how these changes may affect them.**

### Estate Tax Changes

#### Aligning New York and Federal Estate Tax Law

Prior to the enactment of the Budget Legislation, New York’s estate tax laws conformed to the federal tax code as it existed in 1998 and provided for a fixed \$1 million exclusion amount from New York estate tax. Given the significant changes to federal tax law over the last 16 years, this meant that much of New York estate tax law was tied to federal laws that no longer exist. Perhaps the most significant disparity was that the federal unified estate and gift tax exclusion amount, which is indexed for inflation, rose to \$5.34 million in 2014 while New York’s exclusion amount was set to remain at \$1 million. The Budget Legislation implements several reforms, discussed below, that apply to the estates of decedents dying on or after April 1, 2014.

#### Graduated Increase in New York Estate Tax Exclusion Amount

Under the Budget Legislation, New York’s estate tax exclusion amount will be gradually increased to the 2013 federal unified gift and estate tax exclusion amount of \$5.25 million by April 1, 2017. The exclusion amount will increase as follows for decedents dying during the following time periods:

On or after April 1, 2014 and before April 1, 2015:	\$2,062,500
On or after April 1, 2015 and before April 1, 2016:	\$3,125,000
On or after April 1, 2016 and before April 1, 2017:	\$4,187,500
On or after April 1, 2017 and before January 1, 2019:	\$5,250,000

After January 1, 2019, the New York exclusion amount will be indexed for inflation from 2010, linking it to the federal unified estate and gift tax exclusion amount. This change will effectively eliminate the New York estate tax for many residents, and provide significant estate tax relief for others.

Despite the relief offered by the increased exclusion amount, residents with significant assets should be aware of the potential tax “cliff” for sizeable estates. Under the Budget Legislation, the applicable credit amount is to be phased out for New York taxable estates that have a value between 100% and 105% of the exclusion amount, and completely eliminated for taxable estates that exceed 105% of the exclusion amount. Thus, if a New York decedent’s taxable estate exceeds the exclusion amount by more than 5%, the entire taxable estate is subject to New York estate tax. For example, if a New York resident dies in 2018 with a New York taxable estate valued at \$5,512,500 (105% of the then applicable exclusion amount), New York will impose an estate tax of \$430,050, even though the estate’s value exceeds the exclusion amount by just \$262,500.

While Governor Cuomo proposed in his 2014-15 Executive Budget that the top rate for New York estate taxes be reduced, this proposal was rejected and the top rate remains 16 percent.

#### Recapture of Certain Lifetime Gifts in New York Decedents’ Gross Estates

The Budget Legislation will increase the size of some New York residents’ gross estates by recapturing gifts made during their lifetimes. However, this provision will be in effect only for a five-year period and is subject to some significant limitations.

New York’s gift tax was repealed effective January 1, 2000, allowing New York residents to make lifetime gifts free of New York tax. However, under the Budget Legislation, the New York gross estate of a resident decedent will now be increased by the amount of any taxable gift, as determined for federal gift tax purposes, that is made during the three-year period ending on the decedent’s date of death and is not otherwise included in the estate. However, this recapture provision applies only to gifts made on or after April 1, 2014 and before January 1, 2019. The provision also excludes any gifts made when the decedent was not a New York resident.

The lifetime gifts includible in a resident’s gross estate for New York tax purposes under the Budget Legislation generally will not be includible in his or her gross estate for federal tax purposes. Since federal law only allows a deduction from a decedent’s federal taxable estate for the amount of any state estate taxes paid “in respect of property included in the gross estate,” a federal deduction likely will not be available to offset the costs of this provision.

#### Repeal of New York Generation-Skipping Transfer Tax

The Budget Legislation repeals New York’s generation-skipping transfer (“GST”) tax, which like New York’s estate tax was based on and tied to outdated federal laws. Prior to the enactment of the Budget Legislation, New York imposed GST tax based on a federal credit for state GST taxes that expired in 2004. Like that now-defunct federal credit, the New York GST tax applied only to a few specific types of generation-skipping wealth transfers, such as trust distributions occurring as the result of an individual’s death. These limitations meant the tax affected only a few dozen taxpayers each year, yet it was a

frequent source of taxpayer confusion. The Budget Legislation repeals the New York GST tax for the estates of all decedents dying on or after April 1, 2014.

#### Independent New York Election for Qualified Terminable Interest Property

Qualified terminable interest property (“QTIP”), which is held for the exclusive benefit of a surviving spouse (for example, in a marital trust), will qualify for the unlimited marital deduction from federal estate tax only if the decedent’s estate makes a valid QTIP election on its federal estate tax return. The Budget Legislation permits an estate that is not required to file a federal estate tax return to qualify for the New York marital deduction by making an independent QTIP election on its New York estate tax return. If the estate does file a federal estate tax return making a QTIP election, the estate must make a consistent election on its New York return.

### Income of Certain Trusts Now Subject to New York Income Tax

#### New York Resident Beneficiaries Taxed on Distributions of Accumulated Income from Exempt Resident Trusts

Under prior law, New York did not tax the accumulated income of so-called “exempt resident trusts.” Exempt resident trusts are New York resident trusts under the State’s tax code, but are exempt from New York income tax if (i) all of their trustees are domiciled outside New York, (ii) they hold no real or tangible property located in New York and (iii) they derive income and gains only from or in connection with sources outside of New York.

Under the Budget Legislation, New York resident beneficiaries of exempt resident trusts will be taxed on distributions of the trust’s accumulated net income. As a result, beneficiaries will be subject to tax if the trust’s distributions exceed its distributable net income for the tax year, although a credit is allowed for taxes paid to the state by the trust in prior years on its accumulated income, and for taxes paid to other jurisdictions. In addition, exempt resident trusts will now be required to file information returns in New York for any year in which accumulated income is distributed. The Budget Legislation makes corresponding changes to the New York City Administrative Code’s income tax provisions.

While Governor Cuomo’s 2014-15 Executive Budget also proposed taxing New York beneficiaries of nonresident trusts on distributions of accumulated net income, this proposal was not enacted.

This Budget Legislation provision applies to tax years beginning on or after January 1, 2014. However, under its transitional rule, beneficiaries are not subject to tax on distributions of accumulated net income made before June 1, 2014. The tax also will not apply to distributions of income accumulated in taxable years before January 1, 2014, before the beneficiary became a New York resident or before the beneficiary reached the age of twenty-one.

#### Grantors Taxed on Income of Incomplete Gift Non-grantor Trusts

The Budget Legislation also addresses incomplete gift non-grantor trusts (“ING trusts”) created by New York residents, which in the past have not been subject to New York income tax. An ING trust is structured so that the grantor’s transfer of property to the trust is an incomplete gift, but the trust’s governing instrument does not include any provisions that would cause the grantor to be treated as its “owner” for federal income tax purposes. If the grantor were treated as the trust’s owner, then for federal and New York purposes the trust’s income and gains would be taxable to the grantor.

Under the Budget Legislation, the income of an ING trust established by a New York resident will be included in his or her current income, effectively treating the grantor as the trust’s owner even though he or she does not retain enough interest in or control over the trust to be deemed its owner for federal income tax purposes. The Budget Legislation also makes corresponding changes to the income tax provisions of the New York City Administrative Code.

While this Budget Legislation provision applies to tax years beginning on or after January 1, 2014, its transitional rule excludes from tax the income earned by any ING trust liquidated on or before June 1, 2014. New York grantors of ING trusts should discuss the tax implications of this legislation with an advisor.

## Planning Considerations

In light of the changes the Budget Legislation makes to New York tax law, New York residents may wish to review their estate plans with the following key considerations in mind:

- New York residents whose estates will likely be valued slightly in excess of 105% of the New York estate tax exclusion amount should consider the effect of the estate tax “cliff” discussed above. Making charitable bequests can reduce the size of a New York resident’s taxable estate and thereby avoid the negative impact of the estate tax cliff, while at the same time benefiting charitable organizations.
  - Married New York residents whose estates will likely be valued in excess of the New York estate tax exclusion amount should review how their estate planning documents fund trusts that will not qualify for the marital deduction, such as “bypass,” “credit shelter” or “disclaimer” trusts. If their estates are likely to be valued below the federal estate tax exclusion amount, couples can take full advantage of New York’s increased estate tax exclusion amount by funding these trusts with an amount equal to the New York exclusion amount. If these trusts are instead funded with the full federal exclusion amount at the first spouse’s death, New York estate tax will be imposed on the portion of the federal exclusion amount that exceeds the New York exclusion amount.
  - New York residents making lifetime gifts between April 1, 2014 and December 31, 2018 should consider the possibility that the value of their gifts will be includible in their estates if they die within three years. The potential impact of this inclusion on estate tax liability should be considered before significant gifts are made while the recapture provision is in effect.
  - Trustees or distribution committees of ING trusts created by New York residents should consider liquidating or decanting such trusts before June 1, 2014.
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