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Planning Around NY's Estate Tax Cliff-Because a Pandemic Is Enough To Worry About

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The unprecedented impact of COVID-19 has led to an invigorated emphasis on estate planning for many New Yorkers. Faced with a stark reminder of mortality, clients are motivated to take advantage of low interest rates, diminished asset values and the current record-high federal gift, estate and GST tax exemption amounts, especially in light of the upcoming November 2020 election which may bring changes to the estate planning landscape with reduced federal exemption amounts, increased tax rates and elimination of the automatic step-up in basis.

The balance of 2020 will most certainly be a busy time for New York's estate planning attorneys. As such, it is an excellent time to review the current New York Estate Tax regime, with a renewed warning of the dreaded "cliff" and a discussion of how intelligent and flexible planning can help provide security, savings and sometimes even the elimination of the New York estate tax.

New York is in the minority of states that has its own estate tax regime, thereby forcing New Yorkers to think about New York estate tax liability in addition to possible federal estate tax liability. The New York estate tax is computed based on the tax table found on the New York State Estate Tax Return-Form ET-706, which sets forth an increasing rate of tax to be applied as the amount of the New York taxable estate increases. The top rate of 16% applies for New York taxable estates over $10,100,000, and amounts below that are subject to tax at the stated graduated rates, beginning at 3.06% for the first $500,000.

The New York basic exclusion amount is then used to determine whether an estate must file a Form ET-706, and if so, whether and how much credit will be allowed to offset the estate tax. It has been over six years since New York revised its estate tax law, thereby increasing the basic exclusion amount from $1 million to $2,062,500 for estates of decedents with dates of death on or after April 1, 2014 and further increasing in increments until Jan. 1, 2019 when the basic exclusion amount would equal the federal exemption amount in effect prior to the Tax Cuts and Jobs Act of 2017, indexed for inflation. The current New York basic exclusion amount is $5,850,000, significantly less than the 2020 federal exemption, currently $11,580,000.

If the amount of the New Yorker's federal gross estate, plus the amount of any includable gifts (to be discussed below) is less than or equal to the basic exclusion amount, then the filing of a Form ET-706 is not required. Further, if the New York taxable estate is less than or equal to the basic exclusion amount, then the applicable credit amount will equal and wipe out the amount of tax that is computed on the taxable estate. Things get interesting (a/k/a complicated and terrible) from here.

If the New York taxable estate is greater than the basic exclusion amount but less than 105% of the basic exclusion amount (i.e., taxable estates in the $5,850,000 to $6,142,500 range), then the credit shrinks and is equal to the estate tax that would be due on an amount computed by multiplying the basic exclusion amount by one minus a fraction, the numerator of which equals the New York taxable estate minus the basic exclusion amount, and the denominator of which equals 5% of the basic exclusion amount.

Once the New York taxable estate reaches 105% of the basic exclusion amount, the credit disappears entirely, and the entire estate, not merely the amount above the basic exclusion amount, is taxable. This rapid phase out and complete elimination of the applicable credit is what estate planners refer to as the New York estate tax "cliff."

The impact of falling off New York's cliff is draconian and unfair. If New Yorker #1 dies today with a New York taxable estate of $5,850,000, no New York estate tax is due and his heirs receive $5,850,000. If New Yorker #2 dies today with a New York taxable estate of $6,150,000, then his estate owes $529,200 in New York estate tax, and his heirs receive $5,620,800. As a result of the cliff, New Yorker #1's heirs are in a better position than New Yorker #2's heirs, even though New Yorker #2 has a higher taxable estate.

Fortunately, New Yorkers can take action with a carefully prepared estate plan in order to maximize use of the basic exclusion amount and minimize exposure to the dreaded estate tax cliff.

Move or move your assets out of New York. Assuming the extreme solution of leaving New York, which presents its own challenges, is not a realistic option, New Yorkers might consider shifting the location of certain property out of the state. Real and tangible personal property located outside of New York is not subject to New York estate tax.

Make gifts. New Yorkers should consider making gifts in excess of the basic exclusion amount in order to reduce their taxable estates. New York has no gift tax (New York's neighbor, Connecticut, is the only state with its own gift tax), and the federal gift tax exemption is a record high $11,580,000 for an individual. Gifting provides the additional benefit of allowing appreciation of the gifted assets to occur outside of the donor's taxable estate. Married New Yorkers that are concerned about gifting too much might consider use of a spousal lifetime access trust (SLAT) in order to provide comfort that gifted amounts could still be available if needed through distributions to the spouse.

In making lifetime gifts, the New Yorker should be mindful of the assets he or she chooses to gift. Making a gift of low basis assets, for example, transfers that low basis to the transferee while allowing those assets to pass as part of the New Yorker's estate gives the transferee a step-up in basis to the fair market value at death. Also, if the donor dies within three years of making the gift, the value of the gift is "clawed back" into the New Yorker's taxable estate, putting the estate in the same position as it would have been if the gift was never made.

Add conditional charitable bequests to estate planning documents. New Yorkers should consider updating their wills to include what some estate planners affectionately refer to as a "santa clause"; that is, a provision that directs the executor to make a charitable bequest if doing so would reduce the taxable estate to the basic exclusion amount, thereby resulting in a larger amount passing to heirs. This is a particularly attractive option for New Yorkers teetering near the edge of the New York estate tax cliff.

Include flexible structures for married New Yorkers. Unlike the federal law, New York does not allow the deceased spouse's executor to elect to transfer any amount of unused basic exclusion amount to the surviving spouse; that is, New York does not recognize the "portability" of a deceased spouse's unused exclusion amount. Therefore, married New Yorkers should consider planning to maximize use of the New York exclusion upon the death of both spouses. If all assets pass to a surviving spouse upon the first death, there will be no tax (federal or New York) due to the marital deduction, but the New York exclusion amount will be unused in the first estate. If upon the death of the surviving spouse, his or her taxable estate, including the amount he or she received from the first spouse to die, exceeds 105% of the New York exclusion, then the entire (combined) estate will be taxed.

There are a number of effective strategies for making use of the exclusion amount upon the death of the first spouse. A "credit shelter trust" or "bypass trust" for the benefit of the surviving spouse (or descendants) can be funded up to the New York exclusion amount, thereby locking in the benefit of the exclusion amount at the first death and sheltering the assets from taxation.

Married New Yorkers might also consider the flexibility of a disclaimer trust, which would allow the surviving spouse to assess the circumstances at the time of the first death and determine whether a trust to shelter the New York exclusion amount is advisable at the time.

Finally, married New Yorkers should be reminded to consider repositioning assets between them if wealth is held with disparity such that one spouse does not individually hold sufficient assets to take maximum advantage of the New York exclusion.

Conclusion

Like most Americans, New Yorkers have much on their mind these days. Thankfully, through careful planning with their estate attorney, New Yorkers can take action to mitigate the complications and intricacies of the New York estate tax regime and plan to take full advantage of the credit available to offset the New York estate tax.

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