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I. NYS Estate Tax Planning in 2024

The unusual manner in which the estate tax in New York operates is a trap for the unwary and requires a degree of attention unusual even for tax statutes. It is not that the statute is complex, although it is that. Rather, it is the fact that once the threshold exemption is reached — below which there is no estate tax — every quantum of increase in the taxable estate above the threshold exemption amount is taxed in short bursts at astronomical rates nearing 200 percent until the size of the taxable estate exhausts the exemption a short time later, at which point subsequent increases in the taxable estate are no longer taxed at 190 percent, but rather at rates of about 13 or 14 percent. Thus the moniker "cliff."

The exemption of $626,352 is entirely phased out once the taxable estate reaches $6.909 million, which is exactly five percent more than $6.58 million. An increase in the taxable estate of only $329,000 results in a disproportionate estate tax liability of $626,352. The 5% increase ($329,000/$6,580,000) in the taxable estate above $6,580,000 is taxed at 190.4% ($626,352/$329,000).

Percentagewise, the worst effects of the "cliff" are felt at the beginning: The first $20,000 over the exemption amount is taxed at 265%. Yet tax planning is also important throughout the phaseout: A $109,000 increase from $6.8 million to the point at which the phaseout is complete at $6.909 million is still taxed at a confiscatory rate of 117%.

After the taxable estate reaches $6.909 million and accrues a tax liability of $626,352, incremental increases in the relative rate of tax imposed decline dramatically. However, with taxable estates of that size, even small percentage increases in tax rates equate to large absolute tax increases. A $1 million increase in the size of the taxable estate from $7 to $8 million is taxed at 13.52%, resulting in a tax of $135,200. [New York has a graduated estate rate beginning at 3.06 percent increasing to 16 percent.]

The New York tax denies any use of the exemption for large estates; the exemption is a wasting asset. However, it is true that estates above the phaseout do benefit indirectly from the exemption. In both relative and absolute terms, tax planning for taxable estates within the phaseout benefit most from tax planning. That translates to taxable estates between $6.58 million and $6.909 million. It may well be the case that the taxpayer may not be able to reduce a taxable estate of $6.909 million to a taxable estate of $6.58 million to entirely reduce the estate tax. However, the descent from the edge of the cliff, which begins at $6.58 million is long. Any reduction within the 5 percent "window" will save more than one dollar in tax for every dollar the taxable estate is reduced. The first $20,000 over the cliff is taxed 265%, the last $109,000 before the phaseout is complete is taxed at 117%. The entire $329,000 from beginning to end of the phaseout is taxed at 190%.

The confiscatory nature of the tax is best illustrated by example: Assume A has a taxable estate of exactly $6.58 million. Taxpayer B has a taxable estate of $6.909 million. The estate of A would owe no tax, while the estate of B would owe estate tax of $626,352. After the payment of estate tax, the estate of B would have assets worth

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$6.283 million. Yet the estate of A would be worth $6.580 million, 4.7 percent more. The estate of A, which was worth $329,000 less than B, but incurred no estate tax, would end up with $297,352 more than the estate of B. This after B's payment of estate tax, calculated by imposing a 190 percent rate on the $329,000 difference between the size of the two estates.

The confiscatory nature of what occurs during the phaseout seems difficult to defend from a tax policy standpoint. The rapidity with which an estate incurs no estate tax to an estate that incurs an estate tax of $626,352 is only $329,000. It is puzzling why a taxable estate of $6.58 million would owe no tax, but a taxable estate worth only $20,000 more would owe $53,760.

II. Planning Overview

Planning in the federal gift and estate tax realm is less important today due to the $12.92 lifetime exemption. However, along with many other provisions of the 2017 Tax Act passed during the Trump Administration, the present gift and estate exemption amount is scheduled to "sunset" at the end of 2025. At that point, the federal exemption will revert to $5.3 million.

This factor complicates estate tax planning somewhat, because the planning must take into consideration whether the federal exemption amount becomes less than today. Making tax planning more complex is also the fact that the federal exemption is portable; any unused exemption at the death of the first spouse will be "ported" to the second spouse for his or her own use. However, New York does not recognize portability. Tax planning with divergent exemption amounts and differences in "porting" requires a coordination of federal and New York tax rules.

With respect to the porting issue, it may be undesirable to burden the estate of a surviving spouse of assets he or she might not need, since that might directly result in estate tax at confiscatory rates if within the 5 percent exemption phaseout window. However, it is also a truism that "the tax tail should not wag the dog." One might reasonably decide to burden the estate of a surviving spouse with assets that might later be taxed, if the assets would enhance the life or security of the surviving spouse.

III. Planning Strategies

New York estate tax liability can be reduced through various techniques, including gifting or consuming assets, employing formula clauses, utilizing valuation discounts, making charitable gifts or bequests, utilizing disclaimers, or establishing residency elsewhere. The taxpayer can entirely avoid the estate tax by relocating to a State without the tax, or can reduce or eliminate the tax by establishing residence in a State with a lower estate tax rate or a higher exemption amount. Most states today do not impose an estate tax.

Lifetime Gifts

Gifts made during the donor's lifetime remove the asset from the taxable estate, with one catch: Under Tax Law §§954(a)(3), gifts made within three years of death are "clawed back" into a New York resident's taxable estate. However, neither gifts of real or tangible personal property having a situs outside of New York at the time of the gift, nor gifts made at a time when the decedent was not a resident of New York, are subject to the rule. The clawback statute, which has been extended once, is now set to expire on January 1, 2026.

Credit Shelter Trusts

A credit shelter trust is usually a testamentary trust funded at death with an amount not exceeding the estate tax exemption. A surviving spouse is frequently named the lifetime beneficiary of the trust, with children being residuary beneficiaries. The estate of the taxpayer will not receive a deduction because the transfer is incomplete for gift and estate tax purposes. The

exemption is utilized to avoid current tax liability.

Provided the rights of the spouse are limited, trust assets will not be included in the estate of the surviving spouse at her death. The ultimate beneficiaries will be named in the trust, and cannot be changed by the spouse without the beneficiaries' consent. The spouse may be given the right while living to all or a part of the trust income. Distributions of principal, if allowed by the trust, must be limited to those made for "health, education, maintenance and support" or a similar ascertainable standard. If the trust grants too many rights to the surviving spouse, the risk is that the assets will be included in the estate of the surviving spouse at his or her death.

Trust assets are provided a substantial degree of protection from claims of creditors. Such creditors could include the creditors of the surviving spouse, or later creditors of the children when they become beneficiaries. Considerable asset protection is provided discretionary rather than nondiscretionary distributions. If a beneficiary is entitled to all income, then less credit protection is provided. However, a clause in the trust providing for a suspension of distributions if a creditor issue arises might be of some deterrent effect.

In situations where the surviving spouse is intended to be the sole lifetime beneficiary, both a credit shelter trust and a marital deduction trust might be employed. The credit shelter trust would shelter the estate up to the exemption amount, and the marital deduction trust would provide the estate a deduction for the remainder.

Example

Taxpayer's taxable estate is now $6.8 million. Taxpayer does not wish to make an outright gift to an adult child, but does want to establish a trust for the child's benefit and for the ultimate benefit of his grandchildren. He funds a credit shelter trust with $300,000. His taxable estate is reduced to $6.5 million, $80,000 below the exemption amount. Provided taxpayer lives three years, and assuming the size of his taxable estate remains constant, his taxable estate will be below the estate tax threshold. If taxpayer were to pass within three years, trust assets would be "clawed back" into the estate, and estate tax liability of $499,200 would arise.

Use of a charitable gift hedge, discussed below, can lessen the effect of an untimely death within three years.

If the taxpayer does not wish to part with the funds now, the taxpayer could establish the same trust in will, making the bequest testamentary. If the taxpayer's estate were to remain constant, his estate would incur estate tax liability of $499,200. Note the identical tax liability would arise if the taxpayer's will simply bequeathed the amount funding the credit shelter trust outright instead. The use of the credit shelter trust does not provide a deduction to the estate. However, if the child's rights were limited, then trust assets would not be included in the child's estate when the child died.

Use of a charitable gift hedge, can also mitigate the effect of the estate tax if contained in a properly drafted testamentary instrument.

The principal advantage in making the gift to the trust now rather than making it at death lay in fact that New York does not tax lifetime gifts provided the taxpayer lives for three years after making the gift. If the taxpayer lives for three years after making the gift, the taxpayer will not deplete any part of his lifetime estate exemption by making the gift, and his taxable estate will be reduced by the size of the gift.

While it is true that the taxpayer will always have $300,000 less during his lifetime if he funds any trust (with respect to which he is not a beneficiary) by that amount, by so funding the trust during his life, estate tax savings may be disproportionate to the amount of the funds gifted to the trust. Many taxpayers will not part with a large sum of money which they might need in the future, even if it would operate to reduce estate taxes.

For large estates, the use of substantial

lifetime gifts could result in significant tax savings, and are among the most simple tax planning techniques to employ. Nevertheless, many taxpayers contemplating making large gifts might be unwilling to accept the three-year waiting period.

Marital Deduction Trusts (QTIP)

Establishing a marital deduction trust for a surviving spouse will enable the taxpayer to utilize the available exemption on other testamentary transfers, since a testamentary bequest in the form of a qualifying trust to one's spouse qualifies for a complete marital deduction.

Such a "QTIP" trust must contain certain provisions which both limit surviving spouse's rights to trust property but also insure that the surviving spouse will be paid all of the income from the trust paid no less frequently than annually. In most cases, the trust will not provide for an invasion of principal for the benefit of the surviving spouse.

The QTIP trust is ideal in second marriage situations, since the taxpayer may wish to provide benefits to a second spouse, but may not want the spouse to determine the ultimate beneficiaries of the trust. Ultimate beneficiaries are determined by the taxpayer creating the trust; the surviving spouse has no power to alter the beneficiary designation.

[Since the QTIP trust does not satisfy the right of election in New York, a waiver by the beneficiary spouse would likely be required to prevent the spouse from electing against the QTIP in favor of an outright distribution, unless other assets left to the surviving spouse independently satisfied the spouse's statutory right to a percentage of the estate.]

The QTIP is useful where the entire exemption amount has already been applied by the taxpayer. Suppose that after gauging one's taxable estate, it appears that $250,000 will remain taxable after the exemption has been fully utilized. If the spouse is married, he or she can implement a marital deduction trust to dispose of the excess, even if the spouse has received some of the assets to which the exemption applied. The trust will provide a complete deduction to the decedent's estate, and will reduce the taxable estate perhaps to the threshold exemption amount, or below it. The surviving spouse must include the fair market value of appreciated trust assets in his or her estate at death (since the predeceasing spouse's estate received a deduction).

Note the difference in tax treatment compared to what occurs when the surviving spouse beneficiary of a credit shelter trust dies. In that case, no estate tax inclusion occurs because the gift to the trust was complete. Tax was avoided because of the exemption. With the QTIP trust, the gift is incomplete and a deduction is provided to the spouse creating the QTIP on condition that the surviving spouse include trust assets in his or her estate at death.

Disclaimers

A testamentary bequest can be disclaimed within nine months of death. When a bequest is disclaimed, it is treated for tax purposes as if the disclaimant predeceased the testator. A bequest may be disclaimed in whole or in part.

Assume taxpayer has a spouse and one child, and has a gross estate of $4 million. Taxpayer's will leaves a bequest of $3 million outright to his spouse, and $1 million outright to his child. This results in a taxable estate of $1 million, the spousal bequest qualifying for the full marital deduction.

Shortly after taxpayer's death, it appears that the taxable estate of the surviving spouse will exceed the sheltered exemption amount by about $1 million, which would subject the eventual estate to an estate tax of about 190%. Rather than accept the $3 million bequest, surviving spouse considers disclaiming $1 million, which would bring her taxable estate below the threshold at which New York estate tax would be imposed.

If spouse were to disclaim, taxpayer's taxable estate would be increased by $1 million due to the loss of the marital deduction, but would

still be sheltered from New York estate tax by the available exemption. If surviving spouse is planning on making a bequest of her estate to the child, and determines that her assets are sufficient, then she might decide to disclaim. A disclaimer would result in neither the estate of the taxpayer nor that of the surviving spouse incurring New York State estate tax liability; both would be sheltered by the exemption.

In this case rather than disclaiming, the surviving spouse could simply make a $1 million gift to her child, which would also reduce the size of her estate below the estate tax threshold. However, there is always the risk that the surviving spouse would die within 3 years, voiding the gift and subjecting the estate to estate tax substantially exceeding the amount of the failed gift.

Valuation Discounts

When property is placed in corporate, partnership, or LLC form, a partial ownership interest has fewer rights than outright ownership. This reduces the value of a partial ownership interest. Valuation discounts are most commonly applied to interests in real estate or closely held family businesses. If the owner of real estate creates a partnership or LLC, and retains most of the interest, but gifts or sells a fractional interest to a third person, the value of what the owner has retained may be entitled to a discount attributable to various limitations inherent in the partnership or LLC form. These include discounts for lack of marketability, lack of control, and a minority interest discount. Valuation discounts of 20 percent for partial interests in real estate or a closely held business are not uncommon.

Charitable Bequests

A charitable bequest may be useful in negotiating the exemption “cliff.” If a will provision states that assets in excess of the exemption amount will fund a charity, New York estate tax may be reduced or avoided. However, there are dangers to using this type of formula provision. Gifts to a charity invoke the involvement of the New York Attorney General. Disputes involving formula clauses could arise over what amount needs to be given to the charity. Unwanted administrative issues may also arise. Involvement with Attorney General’s office to reduce estate taxes seems like an undesirable tradeoff. If one is charitably inclined, then an outright gift of a sum certain, which will accomplish approximately the same purpose, seems preferable.

Charitable Gift Hedging

The three year “clawback” rule for gifts will soon expire. It may or may not be extended. One option for insuring that the estate will benefit would be to make a conditional charitable bequest, dependent upon the status of the clawback rule. If the clawback statute expires then the conditional charitable bequest would expire with it due to the failure of a condition precedent. If the clawback were extended, and decedent died within three years of the gift, then the charitable gift of an amount necessary to provide a deduction to eliminate the estate tax would be made. This would prevent the excess over the allowable exemption amount to be taxed at rates of up to 190%.

Establishing Legal Residence in Another State

Jurisdictions that impose an estate tax are concentrated in the northeast and in the far west. Every state in New England except New Hampshire has an estate tax. (Connecticut has a $9.1 million exemption and a flat tax rate of 10.8% to 12%; whereas Massachusetts has an exemption of $1 million, with rates ranging from 0.8% to 16%.)

Among mid-Atlantic States, New York has an estate tax, while New Jersey and Pennsylvania assess an inheritance tax but no estate tax. Delaware also has no estate tax. No state south of

Delaware and east of the Mississippi has an estate tax, except Maryland, the District of Columbia, and Illinois. Minnesota, Washington, Oregon and Hawaii comprise the remaining states with an estate tax.

For those considering relocating, the best plan would be to go south or west — even to California. Jurisdictions having no estate tax include, but are not limited to Arizona, California, Colorado, Florida, Georgia, Nevada, New Hampshire, New Mexico, South Carolina, Tennessee, Texas, Utah, Virginia, and West Virginia.

Changing one's residence to another state, if successfully established, will result in the taxpayer no longer being subject to New York estate tax. However, a change of residence is less effective if one's family still resides in New York and one makes frequent trips to New York, or if one wishes to visit New York frequently, or if one makes frequent business trips to New York. Retaining a physical place to reside while visiting New York makes renouncing one's new York residence nearly impossible.

The residency rules are complex and the Department of Taxation takes aggressive positions. Disputes with the Department not settled in audit are reviewable by the Division of Taxation, an administrative tribunal. Adverse determinations are appealable to the Tax Appeals Tribunal and then to the Appellate Division, Second Department, in Albany.

If one plans to leave New York, the fewer contacts maintained with New York, the less likely the Department of Taxation will audit, and the less likely the taxpayer will end up receiving letter "determining" that the taxpayer owes tax, interest, and penalties. The most propitious time to resolve the dispute may be at the audit stage. The auditor may want to get the file off his or her desk, and be credited with closing the case. Even in situations where the taxpayer's position has some merit, all but the most meritorious cases seem to be winnowed out in litigation. Resort to tax litigation in New York's administrative tax tribunals, from a purely statistical standpoint, seldom bears fruit.

IV. Conclusion

Many strategies can reduce or eliminate the incidence of estate tax, whether the estate is within the exemption phaseout spectrum, or beyond it. The "cliff" feature of the tax is truly a trap for the unwary. Even a modest amount of estate planning can prove extremely effective in blunting the confiscatory rate of tax imposed on taxable estates between $6.58 and $6.91 million; and the nonconfiscatory, but nevertheless high tax rates imposed estates greater than $6.91 million.