New York State Bar Association

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TRUSTS AND ESTATES LAW SECTION

Comments on Part I and Part X of Revenue Article VII Legislation

T&E #7 March 3, 2014

S. 6359-B, Parts I and X By: BUDGET
A. 8559-B, Parts I and X By: BUDGET
Senate Committee: Finance
Assembly Committee: Ways and Means

The Trusts and Estates Law Section of the New York State Bar Association respectfully submits the following comments on certain aspects of the 2014-2015 New York State Executive Budget Revenue Article VII Legislation (the "Budget Bill"), S.6359-B / A.8559-B, including its 21-Day Amendments, namely Parts "X" and "I."

With regard to Part "X," we find the proposed amendments to sections 952, 954, 955, and 960 of the Tax Law[1] to be very positive in general, and support each of them. We will, however, limit our comments initially to the proposed amendments to sections 952, 954, and 960, as follows:

> The amendment to section 952 proposes to reform the New York State estate tax by (i) reducing the maximum New York State estate tax rate from 16% to 10%, to be phased in through April 1, 2017 (§952(b)) and (ii) increasing the applicable credit amount in New York from $1 million to $5.25 million (§952(c)), also to be phased in through April 1, 2017, with indexing for inflation beginning in 2019 so that New York State's estate tax exemption will be approximately equal to the federal estate tax exemption (now $5.34 million). ***We support this proposed amendment, except that we object to the last two sentences of section 952(c), the first of which phases out the credit for a decedent whose New York taxable estate exceeds the basic exclusion amount and the second of which eliminates the credit for a decedent whose New York taxable estate exceeds one hundred five percent of the basic exclusion amount, and urge that both such sentences be removed.***

[1] Unless otherwise indicated to the contrary, all references to "§," "§§," "section" or "sections" are to sections of the New York State Tax Law.

The amendment to section 954 proposes to increase the New York gross estate of a deceased resident by the amount of any taxable gift under section 2503 of the Code[2] made on or after April 1, 2014 if the decedent was a resident of New York at the time such gift was made. §954(a)(3). ***We support this proposed amendment provided that (i) there is a limitation for the period of time over which such gifts can be added back to the New York gross estate, (ii) gifts of real and tangible personal property having a situs outside of New York State are excluded from such gifts, and (iii) gifts included in the gross estate are not also added back.***

The amendment to section 955(b) provides that if a right to any deduction otherwise allowable is waived for federal estate tax purposes, it shall be considered waived for New York estate tax purposes. ***We support this proposed amendment.***

The amendment to section 960(b) provides for the computation of estate tax in the case of a nonresident decedent using a modified version of the New York taxable estate applicable to residents under section 952. Under this modified version, excluded from the computation of the nonresident decedent's New York estate are "the amount of any gift unless such gift consists of real or tangible personal property having an actual situs in New York or intangible personal property employed in a business, trade or profession carried on in this state" (emphasis added). ***We support this proposed amendment except that we oppose its application to lifetime gifts of "intangible personal property employed in a trade or profession carried on in this state."***

The amendment to section 960(d) liberalizes the current exemption for a nonresident's works of art in New York on loan for exhibition at a nonprofit gallery or museum at the time of the nonresident's death. ***We support this proposed amendment. We observe, however, that the first reference to "public gallery" (Budget Bill, page 254, line 2) should be revised to read "public gallery or museum" so as to conform to the corresponding language of the amendment.***

With regard to Part "I," and the proposed amendments to section 612(b), we oppose the addition of new paragraph "(40)" but support the addition of new paragraph "(41)," as follows:

The amendment to section 612(b)(40) proposes to tax New York resident beneficiaries of non-grantor trusts (other than incomplete gift non-grantor trusts ["ING Trusts"]) on accumulation distributions on a throwback tax basis. Such trusts are currently not subject to tax because they (i) are non-resident trusts with

[2] Unless otherwise indicated to the contrary, all references to "§," "§§," "section" or "sections" of the "Code" are to sections of the Internal Revenue Code of 1986, as amended.

no New York source income or (ii) fall within the New York resident trust exception. ***We oppose this proposed amendment as it would create a significant burden not only financially on New York resident beneficiaries, but also administratively on trustees and tax return preparers.***

The amendment to section 612(b)(41) proposes to treat ING Trusts as grantor trusts for New York income tax purposes, thereby subjecting the grantors of such trusts to New York income tax. ***We support the loophole-closing purpose of this proposed amendment but believe that as drafted it causes unnecessary complexity and inconsistencies; instead, we recommend that the same loophole be closed by subjecting ING Trusts to New York tax as resident non-grantor trusts under section 605(b)(3)(D), leaving section 612(b)(41) unchanged from current law.***

DISCUSSION

I. <u>Estate Tax.</u>

A. ***Amendment to Section 952.*** We support the proposed amendment to section 952 to reform the New York State estate tax by (i) reducing the maximum New York State estate tax rate from 16% to 10%, to be phased in through April 1, 2017 (§952(b)) and (ii) increasing the applicable credit amount in New York from $1 million to $5.25 million (§952(c)), also to be phased in through April 1, 2017, with indexing for inflation beginning in 2019 so that New York State's estate tax exemption will be approximately equal to the federal estate tax exemption (now $5.34 million). ***However, we object to the last two sentences of section 952(c), the first of which phases out the credit for a decedent whose New York taxable estate exceeds the basic exclusion amount and the second of which eliminates the credit for a decedent whose New York taxable estate exceeds one hundred five percent of the basic exclusion amount, and urge that both such sentences be removed.***

1. ***General Comments.***

a. We highly commend Governor Cuomo for his efforts to date to bring New York into a competitive position with so many other states by seeking to decrease the top estate tax rate and increase New York's estate tax exemption.

b. As is stated in the Memorandum in Support of the Budget Bill (the "Memorandum in Support"), New York's estate "tax is woefully out of date. It is tied to a federal law that no longer exists in practical effect, because the [Code] has undergone significant amendments over the last 15 years that have not been adopted by New York." The Trusts and Estates Law Section of the New York State Bar Association has, for many years, been seeking legislation that would answer the needs of New York residents by bringing New York's estate tax law into synch with the federal estate tax law. By increasing New York's exclusion amount to $5.25 million by April 1, 2017, with indexing for inflation beginning in 2019 so that it will be approximately equal to the federal estate tax exemption (now $5.34 million), many estates of middle class individuals will no longer be subject to the New York estate tax. However, while the phase down of the top tax rate from 16% to 10% was intended to limit the incentive for New Yorkers to leave the State, this is unlikely to be the practical result. This is because the operation of the credit provided in proposed section 952(c) would, for those residents whose taxable estate exceeds the basic exclusion amount by more than 5%, cause a decedent's entire taxable estate -- including the $1 million currently exempted from estate tax -- to be subject to New York estate tax. Hence, there would still be an incentive for the wealthiest (and presumably most mobile) New Yorkers to emigrate for tax reasons.

2. ***Substantive Comments***. Although we support the Governor's Budget message on January 6, 2014 in which he was reported as having advocated ending the "unnecessary incentive for elderly New Yorkers to leave the state" by "increasing the New York estate tax threshold to $5.25 million and lowering the top rate to 10 percent over four years, [and] beginning in 2019, the State estate tax exemption would equal the Federal exemption, which is indexed to inflation, [which] would exempt nearly 90 percent of all estates from the tax, restore fairness and eliminate the incentive for older middle-class and wealthy New Yorkers to leave the State," and conceptually support the proposed amendment to section 952 which was to have reflected that message, we offer the following comments that we believe will have the effect of further improving the Budget Bill:

a. We question if the calendar year "two thousand twelve" as set forth in section 952(b)(2)(B)(II) was intended as the base year for the consumer price index, since the base year for the federal indexing is set at 2010. As a result, it would appear that there will be a slight discrepancy between the federal applicable exclusion amount (currently $5.34 million) and the New York exemption amount ($5.25 million as of April 1, 2017), despite indexing due to the fact that the base years are different (2010 for federal indexing and 2012 for NYS indexing). See S.6359-B/A.8559-B, page 250.

b. We had also questioned the formula for the inflation adjustment, but, with the exception of our comment in "a" above as to the year 2012 having been used as the base year rather than 2010, we believe that the 21-Day Amendments have corrected our concern as to the formula.

c. While we recognize the need to "phase in" the increase to New York's exemption amount, inasmuch as the federal applicable exclusion amount is currently $5.34 million, in an effort to put New York's estate tax in sync with the federal estate tax, it would seem more logical to phase in New York's exemption amount to reach the level of $5.34

million (rather than $5.25 million) for the period from April 1, 2017 up to January 1, 2019 before indexing commences on January 1, 2019.

d. With regard to section 952(a), we believe that the first sentence should be modified to include the word "taxable" between "New York" and "estate" so that subsection "(a)" reads: "A tax is hereby imposed on the transfer of the New York 'taxable' estate by every deceased individual who at his or her death was a resident of New York state." See S.6359-B/A.8559-B, page 247, lines 42-44. Cf, Code '2001(a).

e. With regard to section 952(c), we do not believe that the last two sentences are consistent with the Governor's statement that he wishes to "restore fairness and eliminate the incentive for older middle-class and wealthy New Yorkers to leave the State." ***Rather, by reducing the credit for those estates that exceed the basic exclusion amount by an amount less than or equal to 5% and by eliminating entirely the credit "to the estate of any decedent whose New York taxable estate exceeds one hundred five percent of the basic exclusion amount," this provision is providing "the incentive for . . . wealthy New Yorkers to leave the State." (emphasis added.)***

B. ***Amendment to Section 954.*** We support, in general, the proposed amendment to section 954 that would increase the New York gross estate of a deceased resident by the amount of any taxable gift under section 2503 of the Code, made on or after April 1, 2014 if the decedent was a resident of New York at the time such gift was made, provided that ***We support this proposed amendment provided that (i) there is a limitation for the period of time over which such gifts can be added back to the New York gross estate, (ii) gifts of real and tangible personal property having a situs outside of New York State are excluded from such gifts, and (iii) gifts included in the gross estate are not also added back.***

1. ***General Comments.***

a. We appreciate the fact that although reinstatement of the New York gift tax (repealed in 2000) had been suggested in the Final Report of the New York State Tax Reform and Fairness Commission dated November 2013, the Budget Bill, instead, increases a Resident's New York gross estate "by the amount of any taxable gift under [Code] section 2503, . . . on or after April first, two thousand fourteen, if the decedent was a resident of New York state at the time such gift was made," §954(a)(3). See S.6359-B/A.8559-B, page 250, lines 46-49.

b. We also acknowledge that by adding back such taxable gifts, New York is potentially recouping some of the revenue it will likely be losing as a result of the proposed amendment to section 952, while at the same time somewhat tracking the federal estate tax provisions, albeit such gifts under the Code provisions are treated as adjusted taxable gifts rather than part of a decedent's gross estate.

2. ***Substantive Comments.*** While we support section 954, in general, as it would be amended by the Budget Bill, we have the following comments:

a. Although section 954(a)(1) reduces the value of the New York gross estate, "by the value of real or tangible personal property having an actual situs outside New York state," it is not clear that this reduction applies equally to taxable gifts added to the gross estate by virtue of "(a)(3)." Therefore, there should be specific reference to this reduction in "(a)(3)" or, alternatively, "(a)(1)" should specifically refer to the additions, using the following or similar language:

> "(1) Reduced, after taking into account the increased amounts in paragraphs '(2)' and '(3)' of this subsection '(a)' (due to limited powers of appointment, if relevant, and taxable gifts), by the value of real or tangible personal property having an actual situs outside New York state."

b. More important, however, is that the add back of gifts to a decedent's gross estate is really the reinstatement of a gift tax on a deferred basis, and runs counter to Governor Cuomo's proposal to make New York more competitive with other states, particularly since only two states (Minnesota and Connecticut, currently) have a gift tax. Moreover, the mechanism of adding lifetime gifts to the New York gross estate, even though they are not included in the federal gross estate, would appear to forfeit the federal deduction otherwise generally available for the New York estate tax under Code section 2058(a) (deduction allowable for state estate tax "in respect of any property included in the [Federal] gross estate"). This actually makes New York ***even more uncompetitive*** than it currently is compared to other states and increases, rather than decreases, the incentive for the very wealthy to emigrate.[3] If this element of the Budget Bill must remain at all,

[3] Under Code section 2058, a decedent's estate is allowed a deduction for the amount of estate taxes paid to a State "in respect of any property included in the gross estate. . . ." Because a gift added back to the New York gross estate under section 954(a)(3) will not be property included in the decedent's federal gross estate, presumably no section 2058 deduction will be allowed for the New York estate tax on such gifts, thereby effectively further increasing the tax attributable to those gifts. For example, assuming maximum marginal federal and New York estate tax rates, under current law the combined net federal and New York estate tax (i.e., after taking into account the deduction allowed by Code section 2058) on an incremental $10 million of gross estate would be $600,000 (a 10% New York rate, less a section 2058 deduction of 4% [10% state rate x the federal rate of 40%], or an incremental New York rate of 6.0%). If the same $10 million had been transferred by gift, then under the Budget Bill the net New York estate tax on the gift added back to the New York Gross estate would be $1,000,000 (10%, ineligible for the section 2058 deduction), or an incremental rate of 10% -- a rate 60% higher than incurred on the identical amount by the taxpayer who did not make the gift. Hence, on these facts, the wealthiest New York taxpayers are penalized for the sorts of estate planning gifts that form the foundation of much

the rate of New York estate tax imposed on the portion of the New York gross estate that is not part of the Federal gross estate — that is, the lifetime gifts – should be reduced to what the net cost would have been if the tax had been deductible. Under current rates, that is generally a reduction of 40% of the New York marginal estate tax rate otherwise applicable, although as a drafting matter to accommodate future rate changes, it would be advisable for the Budget Bill to describe the desired result by a non-mathematical formula.

c. If New York is to be competitive, gifts that are added back to the gross estate should be ***limited to those made in the one (1) year prior to death***. This would be consistent with the one (1) year pullback for the elective share under EPTL 5-1-1-A(b)(1)(B). This would also be consistent with the Memorandum in Support, which talks to the inclusion of certain gifts in the gross estate to close "a loophole by preventing deathbed gifts from escaping the estate tax." Again, "deathbed gifts" are generally understood as having been made within one (1) year of death. Similarly, Code section 1014(e) uses the 1-year period ending on the date of the decedent's death with respect to the treatment of appreciated property acquired by a decedent by gift. In addition, since 2011, Maine's estate tax statute limits its pullback of lifetime gifts to a one-year period. See 36 Me. Rev. Stat. §4102(7)(C). See also 72 P.S. 9107(c)(3) (which only pulls back, for Pennsylvania inheritance tax purposes, certain lifetime transfers made within one year of death).

d. Another aspect dealing with the inclusion of taxable gifts in the New York gross estate must be addressed: ***potential double taxation in the New York decedent's estate***. By way of example, when an individual has retained a life estate, at his or her death the remainder is treated as a taxable gift under Code section 2036 (not as an adjusted taxable gift), thereby essentially subjecting the remainder to double taxation in New York. This is because the property (i) would be included in the federal gross estate which, assuming it is not real or tangible personal property outside of New York state, falls within the definition of "New York gross estate" under section 954(a), and (ii) would also be added to the gross estate of a New York resident under section 954(c). The same result might occur due to inclusion of a revocable transfer under Code section 2038 or a transfer subject to Code section 2702. To obviate this situation, the Budget Bill should include a provision for the reduction of any gifts to the extent already included in the federal gross estate. This might also be accomplished as provided in paragraph "(e)" below.

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federal estate planning, in a manner not applicable under current law in this state or in most other states. In addition, this effective marginal estate tax rate of 40% (in the absence of the 2058 deduction) is certainly no improvement over current law, where the 16% marginal New York estate tax rate is ameliorated by the 6.4% benefit of the federal deduction (16% New York rate times 40% federal rate), for a current top New York marginal rate of 9.6%, or slightly lower than the 10% rate imposed under the Budget Bill in these circumstances. Thus, in fact the tax imposed would increase – not decrease – from what it would be under current law, ***contrary to the stated purpose of the proposal***.

e. To ensure that taxable gifts made by a New York resident are not subject to double taxation at his or her death, and that only New York-based gifts made by residents within one year of death are included in the New York gross estate, we recommend that section 954(a)(3) be amended to read as follows:

> Increased by the amount of any adjusted taxable gifts made by the decedent on or after April first, two thousand fourteen if the decedent was a resident of New York state at the time the adjusted taxable gifts were made and the decedent died within one year of making the adjusted taxable gifts. For purposes of the preceding sentence, the term "adjusted taxable gifts" means adjusted taxable gifts as defined by section 2001(b) of the internal revenue code, other than adjusted taxable gifts of real or tangible personal property having an actual situs outside New York state.

C. ***Amendment to Section 960.***

1. ***Conflicting Treatment of Inclusion in Gross Estate and in Lifetime Gifts.*** While we support, in general, the proposed amendments to section 960, we do so with several reservations. The language in proposed section 960(b) "or intangible personal property employed in a business, trade or profession carried on in this state" is questionable. If the intention is to tax such intangibles owned by a nonresident, it would seem that the amendment is defective, since the New York taxable estate of a nonresident is, under the immediately preceding language of section 960(b), already reduced by "the value of any intangible personal property otherwise includible in the deceased individual's New York gross estate." The language of the amendment would have the effect of not reducing the taxable estate by a lifetime gift of such property. We question the policy of imposing estate tax in such a situation when ownership of the same property at death would not be subject to New York estate tax.

2. ***Clarification on Credit.*** We also note that while it otherwise appears that a nonresident decedent's estate is entitled to a New York credit against estate tax, that entitlement could be made clearer by including in Section 960(b) a cross reference to subsection (c) of section 952 (i.e., the subsection that sets forth the credit).

II. ***Income Taxation of Trusts.***

A. ***Amendments to Section 612(b).*** With regard to the proposed amendments to section 612(b), one of which we oppose entirely and the policy behind the other of which we support but urge a different way to reach that goal, it must be noted at the outset that the Memorandum in Support incorrectly states that both of these amendments "reflect the proposals included in the November 18, 2013 report made by the Trusts and Estates Section of the New York State Bar Association to the Tax Reform and Fairness

Commission." In fact, it was the Tax Section – not the Trusts and Estates Section – that submitted the report dated November 18, 2013. Our comments follow:

1. ***Throwback on Accumulation Distributions Section 612(b)(40).*** We oppose the proposed amendment to section 612(b)(40) which would tax New York resident beneficiaries of non-grantor trusts (other than incomplete gift non-grantor trusts ["ING Trusts"]) on accumulation distributions on a throwback tax basis. Such trusts are currently not subject to tax because they (a) are non-resident trusts with no New York source income or (b) fall within the New York resident trust exception in that (i) all trustees are domiciled outside of New York, (ii) the entire corpus for the trust, including real and tangible personal property, is located outside of New York, and (iii) all income and gains of the trust are derived from sources outside New York.

a. Our primary reason for opposing the throwback tax is that it had proven for years (prior to its repeal by Congress for most domestic trusts) to be administratively problematic. As set forth in the Budget Bill, the throwback tax would cause burdens not only to trustees but also to tax preparers. The 21-Day Amendments has shortened the throwback period for the most part, thereby making it less – but nonetheless still – burdensome.

b. Although the throwback tax seeks to collect revenues that would otherwise not be collected by New York under certain circumstances (e.g, income accumulated during a period when the beneficiary was disabled or prior to a beneficiary having a right to receive that income), it strikes us that it is unfair to subject a beneficiary not only to that tax but also to the expense of the throwback tax when the purpose for the accumulation may have had nothing to do with income tax avoidance.

2. ***Closing the Loophole on "ING" Type Trusts Section 612(b)(41).***

a. We support the concept of a revision to the Tax Law to close the loophole represented by ING Trusts. We believe, however, that the proposed amendment to section 612(b)(41) that would treat ING Trusts as grantor trusts for New York income tax purposes, thereby subjecting the grantors of such trusts to New York income tax, is not the best way to accomplish this goal. We think it is unnecessary and unduly complex to create a discrepancy between the federal treatment of these trusts as complex trusts and the proposed treatment of such trusts by New York State as grantor trusts. For example, would a sale between such a trust and the grantor generate capital gain recognition for federal but not New York purposes? And perhaps a different depreciation schedule for the two tax systems (if the sold property is depreciable property)? Would the payment of interest between the grantor and the trust generate ordinary income for federal but not New York purposes? Would the grantor be able to pay the trust's New York income tax without that economic benefit being treated as a gift?

b. We suggest that it would be more consistent with the manner in which trusts are taxed in New York, as well as a more finely-targeted remedy, to modify the statutory safe harbor from New York resident trust income taxation (§605(b)(3)(D)) so that incomplete-gift trusts do not qualify for the nonresident trust exception. As a consequence, such trusts would be treated exactly as they are for federal tax purposes (i.e., separate taxpayers) but would also be subject to New York income tax. That is, the desired result would be achieved in a manner that would be less disruptive to the current taxing structure.

III. *Additional Comments.*

While our initial and primary comments concern the proposed amendments to sections 952, 954, 960, and 612(b), we make the following additional comments regarding the QTIP election and portability, both of which would be beneficial to New York residents, the former by providing additional flexibility and the latter by incorporating the provisions allowable under the Code. By doing so, in each case New York would be integrating its estate tax regime with that of the federal regime, providing consistency (and corresponding ease of administration) and limiting potential conflicts in decision making.

A. *Amendment Regarding QTIP (Sections 955 & 954).*

1. ***General Comments.*** We support this proposed amendment to section 955 that allows for a separate New York State election to be made for qualified terminable interest property, thereby qualifying such property for the marital deduction. The proposed amendment would, however, apply **only if** no federal estate tax return is required to be filed under the Code. §955(c).

2. ***Substantive Comments.***

a. Inasmuch as this amendment is very limited, we urge the legislature to expand this provision to allow a separate QTIP election on the New York estate tax return ***even when a federal estate tax return is required***. This is particularly important where an estate might be below the threshold for filing a federal estate tax return, but "required" to do so solely to elect portability. Subject to specific direction in a decedent's Will, a fiduciary may be conflicted as to making the separate state QTIP election or electing portability.

b. Proposed Tax Law section 954(c) contains a list of the Code sections that may be applicable in determining the New York tax, and those sections are reproduced in full in Tax Law section 999-A – the "Appendix to article twenty-six." While Code section 2044 is included in that Appendix, it would seem that neither that reference nor section 954's definition of a resident's gross estate would include in a surviving spouse's New York or federal gross estate property over which **only** a New York QTIP election is made. Code section 2044 will not apply because no federal QTIP election was made, and section 954 is based on the federal gross estate; that is, as drafted section 954 does not contain a modification that would apply to such property. As the concept behind a QTIP election is deferral, not avoidance, of the imposition of estate tax, section 954(a) should, thus, be amended to add a modification applicable to such property, as well as covering the issue discussed in paragraph c, below.

c. If the surviving spouse releases his or her income interest in a federal QTIP trust, the resulting gift (including the deemed gift of the remainder under Code section 2519) will be included in the New York taxable estate by reason of the application of section 954(a)(3). If, however, no federal QTIP election was made, Code section 2519 will not apply to create a gift of the remainder, and the taxable gift will be limited to the "regular" gift of the income interest. Only the latter would then be included in the survivor's New York gross estate under Tax Law 954(a)(3). This unintended result should also be corrected.

B. ***Portability.*** Finally, we urge that the legislature amend the Tax Law to correspond to the portability rules for estate tax purposes and similarly provide portability of the New York estate tax exemption between spouses for New York State estate tax purposes.

The Trusts and Estates Law Section of the New York State Bar Association respectfully submits the foregoing comments on Part I and Part X of S. 6359-B / A. 8559-B.

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