Estate Planning Alert

New York State Enacts Legislation Reforming Estate, Gift, GST and Trust Income Tax Laws, Including Gradually Increasing the New York State Estate Tax Exclusion From $1,000,000 to the Federal Level (Currently $5,340,000)

Benefits Are Largely Illusory for Wealthier New Yorkers

Coordination of Planning By Couples of Even Greater Importance

Planning Opportunities to Reduce New York and Federal Estate Taxes Remain Viable

April 4, 2014

Although the New York State Legislature rejected New York City Mayor Bill de Blasio’s proposal for an income tax hike for the City’s wealthier residents, the Budget Bill passed on March 31, 2014 falls substantially short of Governor Andrew Cuomo’s objective to provide major estate tax relief to discourage wealthier New York State residents from relocating to states like Florida which do not impose an estate tax.
New York Top Estate Tax Rate Remains at 16%

The Governor’s proposal to reduce the top New York estate tax rate from 16% to 10% was rejected and remains at 16%. (Currently, the New York estate tax is deductible against the Federal estate tax.) Interestingly, in a last minute amendment, the new law only indicates estate tax rates for decedents dying between April 1, 2014 and March 31, 2015. This may be a signal that the Governor intends to propose rate reductions as part of next year’s budget bill.

New York Estate Tax Exclusion Amount Gradually Increases to Federal Level

The Governor’s proposal to gradually increase the New York estate tax exclusion amount from $1,000,000 to the Federal level was enacted. The New York estate tax exclusion amount increases as follows:

<table>
<thead>
<tr>
<th>Date of Death</th>
<th>Exclusion Amount</th>
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</thead>
<tbody>
<tr>
<td>April 1, 2014 to March 31, 2015</td>
<td>$2,062,500</td>
</tr>
<tr>
<td>April 1, 2015 to March 31, 2016</td>
<td>$3,125,000</td>
</tr>
<tr>
<td>April 1, 2016 to March 31, 2017</td>
<td>$4,187,500</td>
</tr>
<tr>
<td>April 1, 2017 to December 31, 2018</td>
<td>$5,250,000</td>
</tr>
</tbody>
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Starting January 1, 2019, the New York estate tax exclusion amount will be indexed for inflation from 2010, which will bring it up to the Federal amount in effect in 2019. (The current Federal exemption is $5,340,000 and subject to annual inflation indexing.)

The increase in the New York exclusion amount is illusory for wealthier New Yorkers. There is a cliff built into the new tax calculation which with a “sleight of hand” quickly phases out the benefits of the exclusion if the decedent’s New York taxable estate (adding back certain taxable gifts made within three years of death) is between 100% and 105% of the exclusion amount available on the date of death; and completely wipes out the benefits of the exclusion if the decedent’s New York taxable estate (and any such gifts added back) exceeds 105% of the exclusion amount available on the date of death. As a consequence, the increase in the New York estate tax exclusion amount only benefits individuals whose New York taxable estates (including certain gifts made within three years of death) fall below the New York exclusion amount in effect on the date of death.

Assuming for purposes of illustration only that the Federal exclusion amount, which is currently $5,340,000 per individual, were to increase to $5,790,000 on January 1, 2019 as a result of annual inflation adjustments of $90,000 per year (comparable to the 2014 increase), the New York exclusion amount would match the Federal amount starting on January 1, 2019. If a New York resident were to die in 2019 with a taxable estate of $6,100,000, which is 105.35% of the (hypothetical) New York exclusion amount of $5,790,000, the New York estate tax would be $522,800 (based upon current rates) and the benefit of the New York exemption would be completely eliminated. In contrast, the estate of a New York decedent who dies in 2019 with a taxable estate equal to or below $5,790,000 would pay no tax.

Certain Taxable Gifts Added Back to the New York Gross Estate

The Governor’s original proposal was to add back all gifts made on or after April 1, 2014 to the New
York gross estate to close a perceived “loophole” whereby New Yorkers could avoid New York estate tax by making lifetime gifts – even on their deathbed – because New York does not impose a gift tax. The Legislature adopted a much narrower provision which only adds back gifts made within three years of death to the gross estate of a New York resident decedent (if such gifts are not otherwise includable in the Federal gross estate).

Furthermore, the add-back does not include any gifts made (i) when the decedent was not a resident of New York; (ii) before April 1, 2014 or (iii) on or after January 1, 2019. (Subject to these limitations, gifts of tangible property and real property located outside of New York are added back.) Although the new law eliminates the New York estate tax savings previously produced by deathbed transfers, as discussed below, there still remains an incentive for New Yorkers to make lifetime gifts to avoid future New York estate tax, provided the individual survives for three years.

New York GST Tax Is Repealed

The New York generation-skipping transfer (“GST”) tax, which only applied to taxable distributions of trusts and taxable terminations of trusts, has been repealed.

Resident Trust Loophole Closed – Throwback Income Tax is Now Imposed on Income Accumulation Distributions Received by New York Beneficiaries

Under the prior tax law, no New York income tax was imposed on a New York resident trust (i.e., an irrevocable trust created by a New York resident or a trust created under the Will of a New York decedent) if all of the following conditions were met: (1) all the trustees are domiciled in a state other than New York; (2) the entire corpus of the trust, including real and tangible property, is located outside of New York; and (3) all income and gains of the trust are derived or connected from sources outside of New York, determined as if the trust were a nonresident. Under the new law, the New York beneficiaries of exempt resident trusts would be subject to a “throwback tax” when distributions of accumulated income are made to them.

Some modifications to the Governor’s initial proposal make the new law less onerous and burdensome to administer. The new law only taxes income accumulated in years beginning January 1, 2014. In addition, it only applies to undistributed net income. Although these changes will be effective immediately and applicable to tax years beginning on or after January 1, 2014, to reduce transition issues, excluded from the throwback tax are distributions of accumulated income by exempt trusts (except ING Trust) made before June 1, 2014. If you are a beneficiary of an exempt New York resident trust who resides in New York, or a Trustee of such a trust, it will be important for you to promptly review these new rules with your tax advisors.

Resident Trust Loophole Closed – ING Trusts Created by New York Grantors Are Now Subject to New York Income Tax

A technique that has been gaining popularity across the nation is the incomplete gift nongrantor trust (“ING Trust”). These are trusts that are structured so that the grantor’s transfer of property to the trust is an incomplete gift and the grantor is not treated as the owner of the income or principal of the trust under the grantor trust rules of Sections 671 through 678 of the Internal Revenue Code.

Under the prior law, a New York resident could create an ING trust in a state with no income tax,
such as Delaware, and as long as the trust qualified as an exempt resident trust for New York income tax by satisfying the conditions described above, the trust income would not be subject to New York income tax. The new law would treat ING trusts created by a New York resident as grantor trusts for New York income tax purposes, causing the income to be included on the grantor’s return.

New Planning Considerations For New York Residents

Because New York has stopped short of reinstating a gift tax, and only adds back to the gross estate of New York resident decedents gifts made within three years of death, there still remain distinct advantages for New Yorkers — particularly those who have not fully used their Federal gift tax exemption (currently $5,340,000 per individual; $10,680,000 per married couple) — to make lifetime gifts. Such gifts will insulate the gifted property from New York estate tax (assuming they survive for three years) and may have the added benefit of reducing their New York taxable estate below the applicable exclusion amount on the date of their death, thereby avoiding the confiscatory impact of the cliff under the new estate tax calculation.

For example, an unmarried New Yorker who has assets with a current value of $5,600,000 and is in relatively good health, may wish to consider gifting $500,000 at this time to his children or other intended beneficiaries. If such person dies on June 1, 2018 (more than three years after the gift is made), when the New York exclusion amount is $5,250,000, with a taxable estate of $5,100,000 his estate will owe no New York estate tax. In contrast, if the gift is not made and the person dies on June 1, 2018 with a taxable estate of $5,600,000, the estate will owe $462,800 in New York estate tax (based upon current rates) due to the cliff effect.

In the case of married couples, coordination of their estate planning is more important than ever before. Lack of planning could lead to the inadvertent loss of the benefits of one or possibly both of their New York estate tax exclusions. The stakes are even greater as the New York exclusion increases over time. Take a couple whose combined assets currently have a value of $6,000,000, with one spouse owning assets worth $2,000,000 and the other having assets worth $4,000,000. If they have a simple estate plan where they leave everything to each other outright under their Wills, and the survivor of them dies on December 15, 2018 when the New York exclusion amount is $5,250,000, the inheritance that the survivor received from the first spouse to die will throw the survivor’s estate over the New York estate tax cliff. Because the survivor’s New York taxable estate will be $6,000,000, which is more than 105% of the New York exclusion amount available on December 15, 2018 ($5,250,000), the New York estate tax imposed upon the surviving spouse’s estate would be $510,800 (based upon current rates).

Under this scenario, neither spouse’s estate would have benefitted from the New York exclusion amount. In contrast, if the couple’s Wills are coordinated so that an amount equal to the New York exclusion amount available on the date of death of the first spouse is left in a credit shelter trust for the surviving spouse (rather than outright or in a trust that qualifies for the marital deduction), there would be no New York estate tax imposed upon either spouse’s estate, thereby increasing the inheritances of the couple’s children or other beneficiaries by $510,800.

One of the reasons why planning to maximize the use of both spouses’ New York exclusion amounts is a bit tricky is that New York does not recognize portability of a deceased spouse’s unused estate tax exemption to the surviving spouse as the Federal law
The New York State Legislature did not heed appeals made by the State and City Bar Associations to adopt the Federal concept of “portability” in the new New York estate tax law.

Perhaps the Legislature may reconsider whether to allow for portability in future legislation, as it would greatly simplify estate planning for New York residents and allow for better coordination of planning for Federal and New York estate tax purposes. Until such time as New York may adopt portability, many New Yorkers will continue to incorporate credit shelter trusts or disclaimer trusts in their Wills to maximize the benefits of both the New York and Federal exclusion amounts.

As demonstrated by the foregoing examples, lifetime gifts could enable a New York resident to insulate the gifted property from New York estate tax (if they survive for three years from the date of the gift) and to possibly avoid the cliff effect built into the New York estate tax calculation by bringing his or her taxable estate below the New York exemption amount applicable on the date of death. New Yorkers who have not fully used their Federal gift tax exemption (currently $5,340,000 per individual; $10,680,000 per couple) may wish to do so to achieve these potential New York estate tax savings and the other advantages of lifetime gifting described below.

**Trifecta for Multi-Generational Estate Planning Continues For Both Federal and New York Planning Purposes**

**For Federal planning purposes:**

In 2014, individuals are able to transfer $5,340,000 free of Federal estate, gift and GST tax during their lives or at death. A married couple is able to transfer $10,680,000 during their lives or at death. And due to the portability of the Federal estate tax exemption, any unused Federal estate tax (but not GST) exemption of the first spouse to die may be used by the surviving spouse for lifetime gifting or at death.

Through coordinated use of their Federal gift and Federal GST exemptions, individuals can create trusts with an aggregate value of up to $5,340,000 ($10,680,000 per couple), which may benefit several generations of descendants while insulating the assets from Federal gift, estate and GST taxes and New York estate tax (provided that they survive for these years).

Prior proposals to limit the protection of such trusts from the GST tax to 90 years have yet to pass Congress, and under prior proposals would only apply to trusts created after the date of enactment.

The annual exclusion gifting amount remains at $14,000 (or $28,000 if spouses elect to split gifts) for gifts made in 2014, subject to indexing in future years.

**For New York Planning Purposes:**

On April 1, 2014, the New York estate tax exclusion amount increased to $2,062,500. Further increases are phased-in over four years with indexing thereafter, so that the New York exemption will match the Federal exemption on January 1, 2019.

New York has stopped short of reinstating a gift tax. Only certain taxable gifts made within three years of death will be added back to the New York gross estate. Thus, there remain distinct advantages for New Yorkers to continue to make lifetime gifts to avoid future New York estate taxes, and possibly the cliff effect of the estate tax calculation (assuming they survive for three years). New Yorkers who have not fully used their Federal gift tax exemption ($5,340,000 per individual; $10,680,000 per couple) have even greater incentives to do so now.
New York also has repealed its generation-skipping tax so that is no longer of any concern.

Unfortunately, New York has not adopted the Federal concept of “portability” of a deceased spouse’s unused estate tax exemption so that maximizing the use of the New York exclusion of the first spouse to die is of great importance, particularly as the exclusion amount increases over the next several years.

Individuals who have exhausted or have come close to using their full Federal gift tax exemptions have additional opportunities to further reduce future Federal and New York estate taxes through other popular wealth-transfer techniques such as by making gifts to zeroed-out GRATS or by leveraging their gifts by sales to intentionally defective grantor trusts.

**Federal Estate Tax Reform May Be On The Horizon**

We have previously written about President Obama’s 2014 budget proposals that would roll back the estate, gift and GST exemptions, increase the transfer tax rates and curtail several popular wealth-transfer techniques, all of which were included in the President’s proposed 2015 budget. See *Stroock Special Bulletin*, April 18, 2013, available at http://www.stroock.com/SiteFiles/Pub1329.pdf.

Although it is less likely that the President’s proposals will be enacted during an election year, the current estate tax law is only “permanent” until Congress enacts new legislation. To the extent that you have not made full use of your Federal $5,340,000 gift and GST exemptions ($10,680,000 per couple), you may wish to do so before Congress may reduce them.

*For now*, the following wealth-transfer techniques which were threatened to be eliminated under prior proposals remain viable:

- Short-term GRATS fewer than ten years
- Valuation discounts
- Sales, exchanges and loan transactions with intentionally defective grantor trusts

**Estate Planning Opportunities**

**Current Tax Law Preserves Popular Wealth-Transfer Techniques that Can Be Used to Leverage Expanded Federal Gift Tax Exemption**

Individuals wishing to reduce future estate taxes by maximizing the use of the increased Federal gift tax exemption should consider utilizing strategies such as GRATs, sales to intentionally defective grantor trusts, or intra-family loans. The interest rates that the IRS uses to value many transfers for estate and gift tax purposes continue to be near their historic lows. With the Federal gift tax exemption currently set at $5,340,000, 2014 may be the right time to implement a gifting plan or enhance an existing plan.

The following are some estate planning techniques that remain particularly attractive under the current tax law.

**Grantor Retained Annuity Trusts**

Grantor Retained Annuity Trusts (“GRATs”) are a very popular technique used to transfer assets to family members without the imposition of any gift tax and with the added benefit of removing the assets transferred into the GRAT from the transferor’s estate (assuming the grantor survives the initial term). It is an ideal vehicle for an individual who has previously used most or all of his Federal gift tax exemption and wishes to shift additional assets to children or other beneficiaries without incurring a significant gift tax or facing valuation issues.

In a GRAT, you transfer assets to a trust, while retaining the right to receive a fixed annuity for a specified term. The retained annuity is paid with any
cash on hand, or if there is no cash, with in-kind distributions of assets held in the trust. At the end of the term, the remaining trust assets pass to the ultimate beneficiaries of the GRAT (for example, your children and their issue or a trust for their benefit), free of any estate or gift tax.

The GRAT can be funded with any type of property, such as an interest in a closely held business or venture, hedge fund, private equity fund, or even marketable securities. The most important consideration is whether the selected assets are likely to appreciate during the GRAT term at a rate that exceeds the IRS hurdle rate (an interest rate published by the IRS every month). The hurdle rate is 2.2% for transfers made in April 2014. Other factors to take into account in selecting the assets to be gifted are whether the assets currently have a low valuation or represent a minority interest (which may qualify the assets for valuation discounts for lack of control and lack of marketability under current law).

Generally, the GRAT is structured so as to produce no taxable gift. This is known as a “zeroed out” GRAT. Under this plan, the annuity is set so that its present value is roughly equal to the fair market value of the property transferred to the GRAT, after taking into account any valuation discounts. There is virtually no gift tax cost associated with creating a zeroed out GRAT.

The value of the grantor’s retained annuity is calculated based on the IRS hurdle rate – the lower the IRS hurdle rate, the lower the annuity that is required to zero out the GRAT. Currently, this interest rate is 2.2% for the month of April 2014.

Why is the interest rate important? Because if the trust’s assets appreciate at a rate greater than the interest rate, the excess appreciation will pass to the ultimate beneficiaries of the GRAT free of any transfer tax. Any asset that you think will grow more than 2.2% a year may be a good candidate for funding a GRAT.

Other benefits of a GRAT bear mentioning. The transfer to a GRAT is virtually risk-free from a valuation perspective. If an asset for which there is no readily attainable market value is transferred to a GRAT, and the IRS later challenges the value that you report for gift tax purposes, the GRAT annuity automatically increases in order to produce a near zero gift. There is essentially no gift tax exposure.

GRATs also enjoy an income tax advantage. A GRAT is a “grantor trust,” meaning that you must pick up all items of income, credit and deduction attributable to the trust property on your personal income tax return. Being saddled with the income tax liability may seem like a burden, but it is actually a great estate planning advantage, in that it allows the trust property to grow income tax free for the beneficiaries, while reducing your estate.

It is important to note that the existing rules that make GRATs so attractive may change in the future. Many bills requiring that the minimum annuity term of a GRAT be ten years have been introduced, and President Obama has once again targeted this popular technique in his 2015 budget proposals. There may be no better time than the present to consider GRATs while the IRS hurdle rate is low and valuation discounts are available.

**Intra-Family Loans**

Another technique that works very well in a low interest rate environment is an intra-family loan. Each month the IRS publishes interest rate tables that establish the lowest rate that, if properly documented, can be safely used for loans between family members without producing a taxable gift.

Currently, these interest rates are near their historic lows. The short-term rate for loans of up to three years is 0.28% for April 2014. The mid-term rate for
April 2014, for loans of up to nine years, is 1.81%. The long-term rate for loans exceeding nine years is 3.32%. Funds that are lent to children, or a trust for the benefit of children, will grow in the senior family member’s estate at this extraordinarily low interest rate, essentially creating a partial estate freeze plan. Those funds, in turn, can be put to use by the junior family member to purchase a residence or to be invested in a manner that hopefully will beat the interest rate.

Making a loan to a trust for your children may be even more advantageous than making a loan outright if the trust is intentionally structured as a grantor trust for income tax purposes. Ordinarily, the interest payments on the note must be included in your taxable income, but if the payments are made by a grantor trust, they will have no income tax ramifications to you.

Sales to Intentionally Defective Grantor Trust

A sale to an intentionally defective grantor trust (“IDGT”) can be an extremely effective planning strategy that takes advantage of the current market conditions; and in the case of a sale of a minority interest, valuation discounts. You would create an IDGT for the benefit of your children, grandchildren and more remote descendants. If there is an existing IDGT, all the better. This is an ideal technique for those clients who created an IDGT in 2013 or prior years.

An IDGT provides two independent planning opportunities. First, you will pay the income tax on the income generated by the trust, including capital gains tax, thereby allowing the trust to grow for your children and their issue unencumbered by the income tax, while reducing your estate. In addition, you may engage in transactions with an IDGT without any tax consequences.

For example, you can sell low basis property to an IDGT without recognizing a gain. President Obama’s 2015 budget proposals include a proposal which would impose an estate or gift tax if a grantor engages in a sale, exchange or “comparable transaction” with his or her grantor trust. The proposal has yet to be passed and would be effective with regard to all IDGTs which engage in such transactions after the date of enactment. If you are contemplating any non-gift transactions with a grantor trust, such as a sale, exchange, lease or loan, you may wish to consider advancing the transaction before Congress may enact such legislation.

An ideal way to lock into valuation discounts, which may be eliminated by future legislation, would be to sell a minority interest in a closely-held business or venture to an IDGT. That minority interest can be sold at a price taking into account discounts for lack of control and lack of marketability.

The elimination of valuation discounts has been the target of several bills previously introduced in Congress. Currently this important planning tool remains intact and the discounts sustained by taxpayers for estate and gift tax purposes are robust. You can still leverage your gift tax exemption by transferring assets that may be subject to lack of marketability and lack of control discounts.

Under this plan, you would sell property to the trust and take back a note with fixed payments of interest and principal. Any property can be sold to an IDGT, but ideally the property would have a low current valuation, good prospects for appreciation and features that enable it to qualify for valuation discounts. If the principal on the note equals the fair market value of the property sold, no taxable gift results. In addition, if the assets earn more than the required interest rate, the excess earnings will retire the principal of the debt, leaving valuable property for your children.
As mentioned below, the interest rates that can be used for this purpose are currently extraordinarily low. Unlike with GRATs, however, such plans may have valuation risks that need to be considered, particularly if the property sold is an interest in a closely-held business or venture.

Although sales to intentionally defected grantor trusts have been used widely for decades, in some recent audits, the IRS has attacked the technique on two fronts: First, by taking the position that the note given to the grantor by the trust in exchange for the purchased property should be ignored resulting in a gift of the full value of the property transferred; and Second, by attempting to treat the note as “equity” in the trust rather than a “debt,” resulting in the inclusion of the asset transferred to the trust in the grantor’s gross estate for estate tax purposes. Although most practitioners believe that IRS’s positions conflict with the Internal Revenue Code, Treasury Regulations and prior caselaw, these audit challenges, coupled with the Treasury’s legislative proposals in 2013 and 2014, which target sales to grantor trusts, may be an indication that the IRS intends to attack such sales more vigorously. The IRS’s assault on sales to grantor trusts is now before the Tax Court in two companion cases including a husband and a wife. In these cases, the note received by grantor contained a defined value formula which provided that if the value of the stock is later determined by the IRS or a court to be different than the appraised value, the number of shares purchased is adjusted to avoid the imposition of a partial gift tax. It is possible that “standard” sales to grantor trusts which do not incorporate defined value formulas may be less susceptible to attack by the IRS. If you are considering a sale or exchange with an IDGT, you should consult your tax advisor about any further developments.

Taking Advantage of Extraordinary Planning Opportunities

In 2014, when the Federal gift, estate and GST exemptions all have increased to $5,340,000, individuals have extraordinary multi-generational estate planning opportunities to use these exemptions through lifetime gifting. Selecting the optimal wealth-transfer technique and the right assets to gift are of paramount importance. The timing of your gifts also should be considered. Federal legislation may be passed setting ten-year minimum terms on GRAT, limiting the effectiveness of intentionally defective grantor trusts and eliminating valuation discounts for transfers of closely held business interests.

For New Yorkers, strategies to reduce or eliminate New York estate tax through lifetime gifting and to maximize the use of the increasing New York estate tax exclusion should be factored into their planning.

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By Anita S. Rosenbloom and Seth D. Slotkin, Partners in the Personal Client Services Practice Group of Stroock & Stroock & Lavan LLP. If you would like to discuss any questions you may have regarding the estate tax laws or estate planning opportunities, please be in touch with any of the members of our Personal Client Services Practice Group listed below.
For More Information

Anita S. Rosenbloom  Seth D. Slotkin
212.806.6026  212.806.6035
arosenbloom@stroock.com  sslotkin@stroock.com

Etta Brandman  Jerome A. Manning
212.806.6027  212.806.6030
ebrandman@stroock.com  jmanning@stroock.com

Ronald J. Stein
212.806.6018
rstein@stroock.com