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Interplay of Federal and New York Estate Taxes Proves Tricky

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Tax planning has never been a picnic and estate tax planning is no exception. New Yorkers must deal with the New York estate tax as well as the Federal estate tax. The recent changes to the Federal estate tax, combined with New York State's pronouncements about how those changes coordinate (or not) with the New York tax, make estate planning for New Yorkers especially tricky. A taxpayer who thinks that the size of her estate does not merit any fancy estate planning might be very unpleasantly surprised.

The Federal estate tax has been a moving target since 2001. Legislation passed in 2001[1] (the "2001 Act") ushered in a decade of shifting exemptions and tax rates. For a brief period, there was "conformity" of the Federal and New York exemption amounts, at $1 million. The Federal exemption gradually increased over the decade, however, reaching $3.5 million in 2009, while the New York exemption remained unchanged, at $1 million. During the same period, the top Federal estate tax rate decreased from 55% to 45%, and the Federal estate tax credit for "death taxes" paid to a State (the "state death tax credit") was replaced by a deduction. The current (2011-2012) Federal exemption is $5 million and the tax rate is 35%.

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State Meets Federal Law

The New York estate tax generally "conforms" to the provisions of the Federal estate tax. New York follows Federal law regarding assets includible in the estate, deductibility of debts and expenses, and the marital deduction for assets passing to a surviving spouse (or to a qualifying marital trust), among other rules. The amount of New York estate tax is based on the amount of the Federal state death tax credit, now repealed; the repeal has no effect for New York estate tax purposes, because New York conforms to the Federal law in effect on a particular date (the "conformity date") prior to the 2001 Act. Based on the former state death tax credit, a top New York tax rate of 16% is imposed on taxable estates of approximately $10 million or more, and the tax on the first $10 million is approximately $1 million. New York estate tax at these rates, together with the shift from a credit to a deduction for Federal estate tax purposes, results in a top effective combined rate of 45.4% for New York domiciliaries dying in 2011 or 2012.

A decedent whose estate is smaller than the exemption amount is generally not required to file an estate tax return. Thus, a New York decedent who dies in 2011 with less than $1 million does not file a Federal or New York estate tax return. If this decedent has more than $1 million and less than $5 million, the estate files a New York estate tax return but not a Federal estate tax return.

"Basis step-up" for income tax purposes is an important corollary to the estate tax. Under this rule, the basis (cost) for income tax purposes of an asset included in the decedent's estate is adjusted (hopefully, upwards or "stepped up") to its fair market value at the date of death. Because New York starts with Federal taxable income, a basis step-up for Federal income tax purposes means a basis step-up for New York income tax purposes as well.

Federal Changes: 2010-12

At the end of 2009, Congress attempted to make the 2009 Federal estate tax law—3.5 million exemption and 45% top rate (53.8% top effective rate for New Yorkers)—permanent. This attempt failed. As a result, the "carryover basis regime" that had been enacted as part of the 2001 Act, effective for 2010 (only), took effect on January 1, 2010. Under the carryover basis regime, there is no Federal estate tax or basis step-up, except for two limited basis increase amounts ($1.3 million general increase and $3 million additional increase for spousal property). This carryover basis regime was the Federal estate tax law of the land for most of 2010. Legislation passed in December 2010[2] (the "2010 Act"), retroactively reinstated the Federal estate tax with a $5 million exemption and a 35% tax rate. The deduction for state death taxes remains in effect, as does the basis step-up, under the 2010 Act.

The 2010 Act also introduced "portability" of the exemption between spouses, effective for 2011 and 2012. A taxpayer's exemption is personal and, prior to the 2010 Act, was lost if not utilized either by lifetime gifts or at death. Portability permits one spouse to transfer his or her unused exemption to the surviving spouse, for use by the surviving spouse (in 2011 or 2012) either through lifetime gifts or at the surviving spouse's later death. Portability must be claimed on the Federal estate tax return of the first spouse to die, even if that estate is not otherwise required to file a Federal estate tax return (for example, because the estate's assets are less than $5 million).

The 2010 Act "sunsets" at the end of 2012. Absent Congressional action, the Federal estate tax will revert on January 1, 2013 to the rules in effect prior to the 2001 Act. Most importantly, this means a $1 million exemption with no portability, a 55% top rate, and the return of the state death tax credit.

By the time the 2010 Act was enacted, most of the year had passed. Many people—some very wealthy—had died. There was lively speculation regarding potential legal challenges to a retroactively reinstated Federal estate tax. Presumably to avoid these issues, the 2010 Act allows the estate of a 2010 decedent to elect not to be subject to (*i.e.*, "elect out" of) the reinstated Federal estate tax regime. An estate that elects out loses the benefit of the basis step-up and is subject, instead, to the carryover basis regime, under which the decedent's historic income tax basis "carries over" to the estate.

Tricky Issues for New Yorkers

The shifting Federal estate tax landscape makes estate planning a challenge, to put it mildly. For New York domiciliaries, the situation is especially tricky. None of the Federal estate tax changes in 2010 or the preceding decade apply for New York estate tax purposes, because they occurred after New York's "conformity date."

Coordination of the Federal and New York estate tax rules is extremely complicated, even for taxpayers with assets less than $5 million. A recent New York State Technical Memorandum[3] ("TSB No. 9") puts New Yorkers on notice that, at every point where New York must determine the effect of the interaction of the Federal and New York estate tax systems, the State will come down squarely on the position that produces the most revenue, seemingly without regard to policy or principles of fairness.

The Marital Deduction Problem

Federal estate tax law contains a "marital deduction" for assets passing outright to a surviving spouse or in a qualifying trust for the spouse's benefit (a "QTIP" trust). The mechanism to obtain the marital deduction for assets passing to a QTIP trust is a "QTIP election" on the deceased spouse's estate tax return. If the election is made, there is no estate tax on the assets passing to the QTIP trust. Assets remaining in the trust at the surviving spouse's death are subject to estate tax at that time, based on their then value and the exemption and tax rates then in effect.

Until 2010, New York required a Federal QTIP election to be made in order to make a New York QTIP election. One of the first questions that arose in 2010 was whether a New York decedent who died at a time when no Federal estate tax was in effect could make a New York QTIP election. TSB-M-10(1)M, issued March 16, 2010, answered this question in the affirmative. TSB No. 9 (issued in 2011, after the Federal estate tax had been retroactively reinstated) clarifies that the New York QTIP election is available *only* when a Federal estate tax return is not being filed (for example, if the decedent's assets are less than the Federal exemption amount, or if the estate of a 2010 decedent "elects out" of the Federal estate tax). If the estate files a Federal estate tax return, it *must* make a Federal QTIP election, even if it does not want or need a Federal estate tax marital deduction, in order to make a New York QTIP election.

Consider Mr. and Mrs. Brown, each of whom has $5 million. Mrs. Brown dies in 2011. She leaves $1 million in a "family" trust for Mr. Brown and their children (sometimes referred to as a "credit shelter" or "bypass" trust) and $4 million in a QTIP trust for Mr. Brown. Mrs. Brown's estate is not required to file a Federal estate tax return and may make a New York QTIP election for the $4 million QTIP trust. The remaining assets in the QTIP trust at Mr. Brown's death are included in his New York taxable estate, but not in his Federal taxable estate (because there was no Federal QTIP election). Accordingly, the remaining assets in the QTIP trust will pass free of Federal estate tax. This is a perfectly appropriate Federal and New York estate tax result. Mrs. Brown died with $5 million at a time when there was a $5 million Federal exemption and her assets pass free of Federal estate tax. The $1 million New York exemption sheltered the family trust assets. Her remaining assets ($4 million) are sheltered by the New York marital deduction until Mr. Brown's later death, at which time New York may impose estate tax based on the rules in effect at that time.

If Mrs. Brown owns slightly more than $5 million, or if Mrs. Brown's $5 million taxable estate consists of $5.1 million in assets and a $100,000 mortgage, the result is quite different. Since her gross assets exceed the Federal exemption, her estate is obligated to file a Federal estate tax return. Under TSB No. 9, the elections on the Federal estate tax return "are binding for New York estate tax purposes," and New York will not permit a New York QTIP election for the QTIP trust, unless the estate makes a Federal QTIP election on the Federal estate tax return. However, a Federal QTIP election jeopardizes the Federal estate-tax-free treatment of these assets at Mr. Brown's later death, potentially causing the remaining QTIP trust assets to be included in his estate for Federal estate tax purposes.

This mechanical "follow the Federal estate tax return" rule also puts pressure on valuation issues. What if Mrs. Brown's estate consists of a difficult-to-value asset, such as an interest in a closely-held business? A significant

New York estate tax consequence (New York QTIP or not) now rides on whether the closely-held business interest is valued at or slightly above $5 million. This is hardly a sensible result.

An interesting question arises regarding the import of a Federal QTIP election where the Federal marital deduction is not required to eliminate the Federal tax. Under Federal estate tax law, a QTIP election generally is not given effect upon the surviving spouse's death (which is when the tax attributable to the QTIP trust assets is imposed) if it was not necessary to zero out the tax at the first spouse's death (when the trust was created). It is not clear what TSB No. 9 means regarding an election on the Federal estate tax return being "binding" for Federal estate tax purposes, in a situation where the election is made but might not be given effect under Federal estate tax law. Can the estate of the first-to-die spouse make a Federal QTIP election solely to satisfy the requirements for a New York QTIP election, and then take the position, when the surviving spouse dies, that the Federal QTIP election should not be given effect for Federal estate tax purposes? This seems inoffensive as a policy matter; the combined estates are simply taking full advantage of the exemptions and deductions that Federal and state laws provide. However, the two estates are taking inconsistent positions. This approach clearly entails some risk.

The Portability Problem

Consider Mr. and Mrs. Blue, New Yorkers with combined assets of $10 million, including their jointly-owned $2 million residence. Mrs. Blue owns $3 million in separate assets and Mr. Blue owns $5 million. Mrs. Blue dies in 2011. Her interest in the home passes to Mr. Blue outright, by operation of law. She leaves $1 million to a family trust and $2 million to a QTIP trust. If Mrs. Blue's estate does not file a Federal estate tax return, it may make a New York QTIP election for the $2 million trust. The result is that $3 million of Mrs. Blue's exemption is "captured" for Federal estate tax purposes; however, $2 million is "wasted." If Mr. Blue dies soon thereafter he will be subject to Federal estate tax on $2 million (excess of $7 million assets over his $5 million Federal exemption), even though the couple's combined Federal exemptions theoretically sheltered their combined assets.

If Mrs. Blue's estate files a Federal estate tax return solely to claim portability for her unused $2 million exemption, a Federal QTIP election must be made in order to make the NY QTIP election. This risk bringing the otherwise "safe" QTIP trust assets back into Mr. Blue's Federal taxable estate. For New York taxpayers not otherwise required to file a Federal estate tax return and who desire to make a NY QTIP election, portability is a problematic choice.

The Basis Step-Up Problem

Consider Mr. White, who owns assets with a value of $10 million and tax basis of $6,000,000, and who dies in 2010. Mrs. White has significant assets of her own and is comfortable letting all of Mr. White's assets pass to the next generation, saving potentially more than $4.4 million in future Federal estate tax, if the Federal estate tax reverts (as scheduled) to pre-2001 levels. Mr. White's estate "elects out" of the Federal estate tax (an election available only to 2010 decedents) and his $10 million passes to the next generation free of Federal estate tax. There is no New York "election out" estate tax, however, and his estate pays approximately $1 million in New York tax.

As explained above, a cost of electing out of the Federal estate tax regime is the loss of the unlimited step-up in the basis of the decedent's assets. Under the 2010 carryover basis regime a basis increase of $1.3 million may be added to Mr. White's $6 million "carryover" basis. A sale of the assets for $10 million generates a $2.7 million taxable gain. No Federal estate tax was paid on this value, but $1 million of New York estate tax was paid. It is hard to believe that New York will impose a second tax (an income tax) on the gain, on which estate tax has already been paid -- but this is the explicit result under TSB No. 9. Since New York follows the Federal income tax and there is a Federal basis step-up of only $1.3 million, the taxpayer is bound by that result for New York income tax purposes.

Conclusion

The 2010 Act may have simplified estate planning for many (subject, of course, to the disappearance of the whole act under the sunset), but it did not achieve any simplification for New York domiciliaries. In TSB No. 9, New York State went out of its way to maneuver within the "disconnect" between the New York and Federal estate tax systems in a manner that creates more New York tax at every opportunity. There does not seem to be much consideration of tax policy or fairness. For those of us who are planning to stay, let's hope the others don't vote with their feet, and move!

[1] The Economic Growth and Tax Relief Reconciliation Act of 2001.

[2] The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.

[3] TSB-M-11(9)M, issued July 29, 2011.