INSIDE THE MINDS

Strategies for Trusts and Estates in New York

Leading Lawyers on Analyzing Recent Developments and Navigating the Estate Planning Process in New York

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Using Portability to Avoid the New York Estate Tax

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Introduction

New York estate planners must be mindful of both New York State and federal estate taxes. Without careful planning, married New York residents may be faced with a state-level estate tax on the death of the first spouse to die even when an estate plan eliminates the imposition of federal estate tax. This possibility exists because of the disparity in the estate tax "exclusion amount"[1] between the federal and New York tax systems. Although the federal system in 2013 provided an exclusion of $5.25 million with annual inflation adjustments, the New York exclusion is only $1 million with no inflation adjustments.[2] This disparity—referred to in tax lingo as a "decoupled exclusion amount"—results in a New York estate tax when a New York resident's will or revocable trust directs the funding of a credit shelter trust in an amount in excess of the New York exclusion.

Until recently, no tax-efficient solution to this problem existed. Although married New Yorkers could have avoided the state-level estate tax on the death of the first spouse to die by funding a credit shelter trust with only the New York exclusion of $1 million (and devising the remainder of the estate to the surviving spouse in a manner that qualified for the marital deduction), doing so increased the size of the surviving spouse's gross estate, possibly subjecting the surviving spouse's estate to a larger tax liability at death. Married New York residents had to pick their poison between two unfavorable tax results.

Because of portability[3]—a recent addition to the federal estate-tax system that awards a surviving spouse with the unused exclusion amount of the first spouse to die—a strategy exists to eliminate the New York estate tax liability on the death of the first spouse to die without increasing the surviving spouse's tax liability. Although this solution yields a favorable tax result, as explained below, it comes with drawbacks for both the decedent and surviving spouse. Married couples will need to weigh these drawbacks against the tax savings.

This chapter begins with an overview of the changes in the federal tax law that has resulted in the above-discussed New York estate tax liability. Next, the chapter explains the strategy married New York residents can use to eliminate New York estate tax without increasing the size of the surviving spouse's gross estate. This section also discusses the drawbacks of using this strategy and whether these drawbacks are worth the tax savings. Finally, the chapter concludes by addressing legislation enacted by other decoupled states and the viability of this solution in New York.

Changes to the Federal Tax Law that Caused the New York Estate Tax Liability

In 2001, Congress enacted the Economic Growth Reconciliation Act of 2001 (EGTRRA), which set the amount of the federal exclusion on a ten-year schedule.[4] Under EGTRRA, the exclusion amount was $1 million in 2002-2003 and steadily increased to a peak of $3.5 million in 2009. Following a year of no federal estate tax in 2010, Congress enacted new legislation that increased the exclusion to $5 million in 2011 and 2012; this legislation also indexed the exclusion amount to inflation.[5] The American Taxpayer Relief Act of 2012 (ATRA) permanently set the exclusion amount to $5 million with annual inflation adjustments.[6] The exclusion in 2013 is $5.25 million. The great state of New York has not mirrored the federal government's generosity. New York law provides that the state will match the federal exclusion but only up to $1 million.[7] Accordingly, the New York exclusion is $1 million with no scheduled increases or inflation adjustments.

New York's decoupled exclusion creates a state-level estate tax liability when a will or revocable trust directs the funding of a credit shelter trust or applicable exclusion trust with an amount in excess of the New York exclusion. The credit shelter trust is

[1] The exclusion amount refers to the amount of assets an individual can transfer without incurring an estate tax liability. The taxpayer receives a credit against the tax that would be owed on transfers of the maximum exclusion amount. For federal tax purposes, the credit—known as the federal unified credit—offsets the tax owed on lifetime gifts and testamentary dispositions. Any amount unused during life is available to offset the tax owed at death. New York does not impose a gift tax. Thus, in New York, the credit offsets the tax owed on transfers at death.
[2] 26 I.R.C. § 2010(c)(3) (West) *and* N.Y. Tax Law § 951(a) (McKinney).
[3] 26 I.R.C. § 2010(c)(4).
[4] Pub.L. No. 107-16, 115 Stat. 38 (2001).
[5] Pub.L. No. 111–312, 124 Stat. 3296 (2010).
[6] 26 I.R.C. § 2010(c)(3)(B).
[7] N.Y. Tax Law § 951(a). After the publication of this article, the State of New York enacted legislation that increases the New York exclusion amount. Over the next five years, the New York exclusion amount is increased incrementally until it matches the federal exclusion amount. After January 1, 2019, the New York and federal exclusion amounts will match each other.

a commonly used testamentary trust that minimizes the combined amount of estate tax paid by a married couple. Traditionally, the first spouse to die funds the credit shelter trust with their complete federal exclusion; doing so "shelters" the assets from being taxed again at the death of the surviving spouse. With respect to New York, a credit shelter trust funded with the full $5.25 million of federal exclusion will only shelter the New York exclusion ($1 million) from a state-level estate tax. New York would tax the estate on $4.25 million. Based on New York's current marginal rates for estate tax, this would result in a tax liability of $420,800.

Example: Harry and Wilma

The following example illustrates the New York estate tax liability that occurs when a New York resident's will or revocable trust directs the funding of a credit shelter trust with the maximum federal exclusion of $5.25 million. Harry, a resident of the State of New York, dies in 2013, survived by his wife, Wilma. In his will, Harry creates a boilerplate credit shelter trust that provides Wilma with an income interest for life; at her death, the remainder is distributed to their children. The will devises the remainder of Harry's property outright to Wilma, thus avoiding estate tax by qualifying for the marital deduction.[8]

The tax consequences of Harry's estate plan are as follows. Harry's estate will pay no federal estate tax. The credit shelter trust does not create a federal tax liability because Harry funded it with his federal exclusion of $5.25 million. The outright disposition to Wilma also avoids federal (and state) estate tax because it qualifies for the marital deduction. However, Harry will owe a state-level estate tax. By funding the credit shelter trust with $5.25 million, Harry will owe a state-level estate tax on $4.25 million because New York excludes only $1 million from estate tax. This amounts to $420,800.

Harry could have avoided this New York tax liability by funding the credit shelter trust with only the New York exclusion of $1 million, but this plan could result in negative tax consequences at Wilma's death. By underfunding the credit shelter trust, Wilma's outright distribution will be increased by $4.25 million. At Wilma's death, these assets (plus any appreciation) will be included in her gross estate. This could create a significant federal and state tax liability on Wilma's death, potentially in excess of the state-level tax liability that Harry would have faced by funding the credit shelter trust with the complete amount of his federal exclusion. As shown above, the decoupled New York exclusion forces married couples to choose between two undesirable tax results.

Using Portability to Avoid the New York Estate Tax

Congress' enactment of portability has provided a new strategy that married[9] New York residents can use to avoid state-level estate tax on the death of the first spouse to die without adverse tax consequences to the surviving spouse. Before explaining this strategy, this section provides a brief overview of portability.

Portability increases the federal exclusion amount of the surviving spouse by the amount of the unused federal exclusion of the first spouse to die.[10] For example, assume Harry died in 2013 and funded a credit shelter trust with only the New York exclusion ($1 million). At death, Harry would have an unused federal exclusion of $4.25 million assuming he made no lifetime gifts over the annual exclusion amount.[11] This amount "ports over" to Wilma. Assuming Wilma also made no such gifts during her life, her federal exclusion would increase to $9.5 million, composed of her own $5.25 million federal exclusion and Harry's unused federal exclusion of $4.25 million. After Harry's death, Wilma could use Harry's unused exclusion to make a tax-free gift of $4.25 million without reducing the amount of her own $5.25 million exclusion.

Practitioners should advise their clients to use the following strategy to avoid the New York estate tax without adverse tax consequences to the surviving spouse. First, the estate plan of the first spouse to die should eliminate the imposition of New York estate tax. The decedent's will or revocable trust should fund the credit shelter trust with only the New York exclusion

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[8] 26 I.R.C. § 2056(a).
[9] The strategy does not apply to unmarried individuals because it relies on two sections of the Internal Revenue Code that apply only to married couples. 26 I.R.C. §§ 2010(c)(4) & 2056A.
[10] 26 I.R.C. § 2010(c)(4).
[11] 26 I.R.C. § 2503(b).

amount. The decedent's remaining assets should be distributed outright to the surviving spouse (or in a trust that qualifies for the marital estate tax deduction) to avoid any federal or state estate tax at the death of the first spouse to die.

The strategy now turns to the surviving spouse. The surviving spouse will have received both an outright distribution of the decedent's assets and the decedent's unused exclusion amount. The surviving spouse should use the ported-over exclusion amount to make a tax-free gift of assets equal in value to the decedent's unused exclusion amount. This will remove the assets from the surviving spouse's estate provided the issues discussed at the end of this section are not present. The surviving spouse should make the gift immediately after the death of the first spouse to die. Once the assets have appreciated, the ported-over exclusion amount will not be sufficient to cover the gift. Additionally, practitioners should encourage the couple to have a plan for making the gift, including whether the gift will be made in trust and the terms for the trust.

Although this strategy can eliminate the above-discussed tax problems, it comes with drawbacks for both the decedent and surviving spouse. The decedent has no control over the assets ported over to the surviving spouse. The decedent cannot guarantee that the surviving spouse will create an *inter vivos* trust nor will the decedent be able to dictate any of the trust's terms. The decedent could include a memorandum accompanying his or her will with requested terms for the trust, but this precatory language will not create any obligation to the surviving spouse. Indeed, the surviving spouse could choose to spend the ported-over assets or create a trust that excludes beneficiaries requested by the decedent. This concern will be most prevalent in second marriages, especially when both spouses have children from their first marriage. The decedent will need to weigh whether the tax savings is worth this loss of control.

This strategy also presents drawbacks for the surviving spouse. The ported-over amount will be subject to the claims of the surviving spouse's creditors.[12] Married couples should not consider this strategy if the surviving spouse has any existing creditors; if so, the outright distribution received by the surviving spouse will only inure to the benefit of their creditors. If the surviving spouse creates a trust with the ported-over exclusion and becomes indebted after creating the trust, the trust's assets should be protected against the claims of the surviving spouse's future creditors provided the surviving spouse did not know of these creditors at the time of the trust's creation and is not named as a beneficiary of the trust.[13] Comparatively, the assets of the credit shelter trust would be protected against the surviving spouse's creditors provided the surviving spouse is named only as a discretionary beneficiary.[14]

Additionally, as compared with the credit shelter trust, the surviving spouse's right to income distributions and ability to serve as trustee must be limited. If the *inter vivos* trust names the surviving spouse as a mandatory income beneficiary, the trust's assets will not escape taxation at the surviving spouse's death (negating the whole purpose for this strategy).[15] Likewise, the surviving spouse should not serve as a trustee unless the trust agreement makes distributions of income and principal subject to an ascertainable standard or names the surviving spouse as a co-trustee without power over trust distributions.[16] Comparatively, in a credit shelter trust, the surviving spouse could receive mandatory income distributions and serve as a co-trustee. Married couples will need to determine if these drawbacks are worth the tax savings.

The Best Solution (State-Only QTIPs) and its Viability in New York

New York is not the only state with a decoupled exclusion amount. Several decoupled states have enacted legislation to eliminate the negative tax consequences caused by decoupling.[17] As explained below, this legislation is generally preferable to the portability-based solution because it yields a similar tax result without any of the drawbacks. These states permit an executor to make a state-only QTIP election. This election enables the first spouse to die to fund a credit shelter trust with the complete amount of their federal exclusion without creating a state-level estate tax. The state-level estate tax is deferred until the death of the surviving spouse, though strategies outside the scope of this chapter are available to eliminate this tax liability.

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[12] N.Y. Est. Powers & Trusts Law § 7-3.1 (McKinney).
[13] N.Y. Est. Powers & Trusts Law 7-3.1(a).
[14] Any distributions made to the surviving spouse would be subject to the claims of creditors.
[15] 26 I.R.C. § 2036(a)(1).
[16] 26 I.R.C. §§ 2036(a)(2) & 2038(a)(1).
[17] These states include Indiana, Illinois, Kentucky, Maine, Maryland, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, and Washington.

The legislation does require more complex drafting. The will of the first spouse to die would need to create at least two marital trusts. Trust 1 would be funded with the state exclusion amount and would operate as a credit shelter trust for federal and state tax purposes. Trust 2 would be funded with the amount that the federal exclusion exceeds the state exclusion. This trust would operate as a credit shelter trust for federal tax purposes; for state tax purposes, the trust would operate as a QTIP trust. By electing state-only QTIP treatment, the transfer to this trust will not be subject to state-level estate tax at the death of the first spouse to die because it qualifies for the marital deduction. At the death of the surviving spouse, the trust's assets will be sheltered from federal estate tax but will be subject to state-level estate tax.[18] To make the state QTIP election, the surviving spouse must receive mandatory income distributions.

If the decedent's estate exceeded the federal exclusion amount, to avoid any estate tax at the death of the first spouse to die, the decedent could distribute the remainder outright to the surviving spouse or create a third trust. If created, Trust 3 would function as a QTIP trust for federal and state tax purposes.

This solution yields a similar tax result to the portability-based solution but without many of the above-discussed drawbacks. The decedent could dictate the terms of the trusts with the exception that any trust that is a QTIP for state or federal tax purposes must provide the surviving spouse with mandatory income distributions. The surviving spouse's receipt of income distributions from a credit shelter trust would not render the trust's corpus included in the surviving spouse's gross estate at death. The surviving spouse's creditors would not be able to reach the trust's assets with the exception of any distributions of income required to be made to the surviving spouse.[19] Finally, the surviving spouse can generally serve as trustee of the QTIP without adverse tax consequences.

The portability-based solution does have one advantage over the above strategy. When the surviving spouse makes a gift of assets equal in value to the ported-over exclusion amount, these assets will not be included in the surviving spouse's gross estate for federal and state tax purposes.[20] By making a state-only QTIP election, the state-level estate tax is deferred to the death of the surviving spouse. Nonetheless, the state-only QTIP election will generally be preferable given the above-discussed drawbacks of using portability. Additionally, as noted above, strategies exist to eliminate the state-level estate tax on the death of the surviving spouse.

Unfortunately, the New York State Department of Taxation and Finance (NYSDTF) has issued two rulings that render making a state-only QTIP election in New York impractical. First, in March 2010, NYSDTF issued a ruling that a state-only QTIP election could be made only when the decedent's estate was not required to file a federal tax return.[21] This appeared to be good news for estates above the New York exclusion but below the federal exclusion because they are not required to file a federal estate tax return.

However, the utility of making a New York-only QTIP election ended when Congress enacted portability. For portability to apply, the decedent's estate must file a federal estate tax return even when the size of the estate is below the federal exclusion amount.[22] Accordingly, the estates of New York residents above the New York exclusion but below the federal exclusion were forced to file a federal estate tax return or the decedent's unused federal exclusion would not port over to the surviving spouse. This raised the question of whether a state-only QTIP election could be made when an estate was not required to file an estate tax return (because it was below the federal exclusion) but chose to do so because of portability.

NYSDTF's second ruling effectively answered this question and cast the death knell in making New York-only QTIP elections. This ruling provided that when an executor files a federal tax return solely to elect portability, the same QTIP

[18] The state-level estate tax consequences would be determined at the surviving spouse's death and would be based on the trust's value on the surviving spouse's death, the state's exclusion amount, and the overall size of the surviving spouse's gross estate. The surviving spouse could avoid the state-level estate tax by moving to a state without one.
[19] If this became an issue, the trustee may be able to invest the trusts' assets to maximize capital appreciation and avoid creating income.
[20] The surviving spouse's *inter vivos* gift of the ported-over assets may reduce his or her New York exclusion amount. For a discussion on the computation of the New York estate tax, see Austin W. Bramwell & Vanessa L. Kanaga, *The Paradoxical Computation of the New York Estate Tax*, 46 NYS Bar Trusts and Estates Journal 4 (December 2013).
[21] Advisory Opinion TSB-M-10(1)M, 2010 WL 991493 (N.Y. Dept. Tax. Fin., Mar. 16, 2010).
[22] 26 C.F.R. *§ 20.2010-2T(a)(1)* (2012).

election made on the federal tax return must be made for New York.[23] For the time being, married New York residents will generally need to rely on the portability solution discussed in this chapter.

Conclusion

New York practitioners should not disregard the state-level estate tax consequences that can result when wills or revocable trusts fund a credit shelter trust with the federal exclusion amount. Fortunately, Congress's enactment of portability has created a strategy to eliminate the New York estate tax at the death of the first spouse to die without adverse tax consequences to the surviving spouse. Despite the effectiveness of this strategy from a tax perspective, practitioners should advise their clients of its drawbacks to both spouses. Notwithstanding its drawbacks, many clients will welcome the opportunity to transfer wealth using this tax-efficient strategy.

Key Takeaways

- Counsel clients on avoiding the New York estate tax without adverse tax consequences to the surviving spouse. The estate plan of the first spouse to die should eliminate the imposition of New York estate tax. The decedent's will or revocable trust should fund the credit shelter trust with only the New York exclusion amount. Remaining assets should be distributed outright to the surviving spouse (or in a trust that qualifies for the marital estate tax deduction) to avoid federal or state estate tax at the death of the first spouse to die. Because of Congress's enactment of portability, the surviving spouse should use the ported-over exclusion amount to make a tax-free gift of assets equal in value to the decedent's unused exclusion amount, to remove the assets from the surviving spouse's estate. The gift should be made immediately after the death of the first spouse to die. Once the assets have appreciated, the ported-over exclusion amount will not be sufficient to cover the gift. Encourage the couple to have a plan for making the gift, including whether the gift will be made in trust and the terms for the trust.
- In devising the plan, make clients aware that the decedent has no control over the assets ported over to the surviving spouse, cannot guarantee the surviving spouse will create an *inter vivos* trust, or be able to dictate any of the trust's terms. The decedent could include a memorandum accompanying the will with requested terms for the trust, but this will not create any obligation to the surviving spouse. Counsel clients on the need to weigh whether the tax savings is worth this loss of control.
- Warn the clients that the ported-over amount will be subject to the claims of the surviving spouse's creditors. Married couples should not consider this strategy if the surviving spouse has any existing creditors, because the outright distribution received by the surviving spouse will then benefit those creditors. If a trust is created with the ported-over exclusion and debt is incurred after creating the trust, the trust's assets should be protected against the claims of future creditors provided these creditors were not known at the time of the trust's creation and the surviving spouse is not named as a beneficiary of the trust. Assets of a credit shelter trust would be protected against the surviving spouse's creditors provided that spouse is named only as a discretionary beneficiary.
- Because of rulings by NYSDTF, state-only QTIPs are not generally a viable solution in New York. Advise clients that married New York residents will need to rely on portability to eliminate the state-level estate tax on the death of the first spouse to die.

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[23] Advisory Opinion TSB-M-11(9)M, 2011 WL 7394600 (N.Y. Dept. Tax Fin., Jul. 29, 2011).

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