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New York Raises Basic Exclusion Amount to $4,187,500

Article By:

Scott A. Bowman

Albert W Gortz

George D Karibjanian

David Pratt

Mitchell M Gaswirth

Andrew M Katzenstein

On April 1, 2016, the amount of property that can pass free of ***New York State*** estate tax is set to rise to $4.1875 million. Approximately two years ago, the New York State legislature passed, and *New York Governor Andrew M. Cuomo* signed, the Executive Budget for 2014-2015, which significantly altered New York's estate tax. The changes to the New York estate tax were made for the ostensible purpose of preventing the exodus of wealthy individuals from New York to more tax-favored jurisdictions, but the law will likely not have the desired effect.

The law increases the New York basic exclusion amount, which was previously $1 million per person. As shown below, this increase will be made gradually through January 1, 2019, after which the New York basic exclusion amount will be equal to the federal exemption amount.

Time Period	New York Basic Exclusion Amount From Estate Tax
April 1, 2015 to April 1, 2016	$3,125,000
April 1, 2016 to April 1, 2017	$4,187,500
April 1, 2017 to January 1, 2019	$5,250,000
After January 1, 2019	Same as federal exemption amount ($5,450,000 as of 2016 but increases each year for inflation)

One of the most significant provisions in the law, however, is that no New York basic exclusion amount will be available for estates valued at more than 105% of the New York basic exclusion amount. In other words, New York estate tax will be imposed on the entire estate if the estate exceeds the exemption amount. Due to adjustments to the bracket structure in the new law, those estates that are valued at more than 105% of the New York basic exclusion amount will pay the same tax as they would have under the prior law.

For example, assume a person dies on May 1, 2016, with an estate valued at $4.4 million. The New York basic exclusion amount will be $4,187,500. Because the value of the estate exceeds 105% of the then available New York basic exclusion amount ($4,187,500 x 105% = $4,396,875), the estate will be subject to New York estate tax on the entire $4.4 million. The New York State estate tax bill will be $324,400, which is the same as the amount that would have been due under the old law. In contrast, if an individual had died with an estate valued at $4.1 million, her estate would owe no New York estate tax under the new law because the New York basic exclusion amount will be applied to her estate. Under the old law, however, the decedent's estate would still have owed $290,800 in New York estate tax.

A significant change in New York law involves certain gifts made during a decedent's lifetime. New York has no gift tax. Under prior law, lifetime gifts were not subject to gift tax or included in the New York gross estate. Under the new law, gifts made within three years of a decedent's death will be added back, increasing the New York gross estate, and thus potentially being subject to New York estate tax at a maximum rate of 16%. However, the add back does not include gifts made before April 1, 2014, on or after January 1, 2019, or gifts made during a time when the decedent was not a resident of New York State.

These changes in New York law present further estate planning opportunities using bypass trusts to set aside New York's basic exclusion amount ($4,187,500 after April 1, 2016 for New York State estate tax purposes). The proper disposition of the basic exclusion amount is the cornerstone of estate planning for married couples. Significant tax savings can be achieved if the basic exclusion amount is set aside at the death of the first spouse, therefore "bypassing" estate taxation at the death to the surviving spouse. In addition, any growth that occurs in the trust also escapes estate taxation at the death of the surviving spouse. As New York's basic exclusion amount rises, the potential tax benefits from employing bypass trusts increase as well.

Valuation Discounts Severely Curtailed: What's All the Hoopla About?

The most successful estate planning techniques pass significant value from one generation to the next by freezing or establishing an appreciating asset's value and shifting the asset's growth to a younger generation. Taxpayers have been able to further benefit from this by using valuation discounts applied to gifts of limited partnership interests, interests in limited liability companies and closely held stock (all of which will be referred to as "family limited partnerships" throughout this article). Congress has previously tried to curtail the use of these valuation discounts through statute, but taxpayers have still been able to benefit from these discounts. Consequently, many individuals have transferred minority interests in their family limited partnerships to their family members at a significantly lower transfer tax cost.

Regulations are expected to soon be issued by the Treasury Department, however, in a new effort to prevent taxpayers from utilizing valuation discounts when transferring minority interests in their family limited partnerships to their family members. Despite these likely regulations, the positive results of removing appreciation from one's estate will still be available to taxpayers. Even once the anticipated regulations are passed, clients can and should continue using other wealth transfer strategies to remove appreciation from their estates. Transferring appreciating assets using grantor retained annuity trusts ("GRATs"), charitable lead annuity trusts ("CLATs") and intentionally defective grantor trusts ("IDGTs") should be considered by anyone who wants to benefit from shifting future appreciation to future generations, and each of which are particularly beneficial in the current low interest rate environments.

GRATs are trusts that benefit from special rules under section 2702 of the Internal Revenue Code (the "Code") for valuing gifted amounts transferred in trust to a member of the transferor's family while the transferor (or family member of the transferor) retains an interest in the trust. Usually the transferor retains an annuity interest in the transferred property while the remainder is given to the transferor's descendants. The retained annuity is calculated based on statutory rates, so if the transferred property appreciates in excess of those rates, that excess benefits the transferor's descendants without further transfer tax consequences.

In a typical GRAT, the taxpayer contributes assets to a trust which provides that he or she is to receive an annuity annually for a fixed number of years. The annuity amount is typically a stated percentage of the initial fair market value of the trust. It can be stated as a fixed percentage or as a percentage that can increase as much as 20% a year over the trust's term.

At all times during the term of the trust, the taxpayer will receive the predetermined annuity amount, regardless of how much income the trust actually generates or whether its value rises or falls. To the extent that the income is insufficient to cover the annuity payments, trust principal will be paid to the taxpayer to make up any shortfall.

At the end of the period, the property remaining in the trust passes to the ultimate beneficiaries of the trust, typically the taxpayer's children or other family members, in further trust or outright, depending upon the taxpayer's preference. Alternatively, the taxpayer can delay the transfer of assets to his or her children by naming a trust for his or her spouse and descendants as the beneficiary until the spouse's death, at which time the taxpayer's children (or other family members) become the beneficiaries.

CLATs are a particularly beneficial technique for taxpayers who plan to make significant charitable gifts in the coming years. In a CLAT, the taxpayer contributes assets to a trust so that an annuity is paid to the charity of his or her choice. Accordingly, the taxpayer receives a current income tax deduction based on the present value of the interest passing to charity. At the completion of the annuity term, the assets remaining the CLAT pass to one or more non-charitable beneficiaries, such as the taxpayer's descendants or trusts for their benefit. If the growth is greater than the IRS rates (2.00% in December of 2015), then the excess appreciation passes to the beneficiaries free of gift or estate tax.

Sales to IDGTs are another technique that allows taxpayers to achieve significant transfer tax savings. A sale to an IDGT involves the sale of an asset to a trust created by the transferor whereby the trust issues a promissory note with a stated interest rate and principal amount in exchange for the asset. The interest rate must be at least equal to the applicable adjusted federal rate ("AFR") at the time of the transfer in order to avoid the transfer being deemed as a part sale, part gift. The trust's beneficiaries are usually the transferor's descendants in order to maximize the transfer tax benefits. Additionally, unlike a GRAT or a CLAT, a sale to an IDGT potentially allows the taxpayer to also minimize applicable generation-skipping transfer ("GST") taxes that may otherwise be imposed by allocating GST exemption to the trust (the GST exemption in 2016 will be $5,450,000).

Simply stated, one can transfer valuable assets to younger family members while reducing the transfer tax costs by transferring appreciating assets to the recipients. Doing so locks in the value of the asset for gift tax purposes and shifts the future appreciation to the recipient while also reducing the value of the transferor's estate.

Classic estate planning techniques like GRATs, CLATs and sales to IDGTs are available to help taxpayers freeze the value of the asset they wish to transfer. By freezing the value of the asset, the taxpayer will be able to get the asset out of his or her own estate and shift future appreciation to the recipient descendants. Moreover, partial interests can still be transferred through these methods as well, even if valuation discounts are no longer available.

Zeroed-out GRATs provide taxpayers with a low risk avenue to accomplish this and can be especially beneficial in a low interest rate environment. Making a gift through a CLAT can also transfer appreciation to a taxpayer's descendants free of transfer tax, while providing the taxpayer the additional benefit of an immediate income tax charitable deduction. Sales to IDGTs are also beneficial in a low interest rate environment, and provided that the taxpayer can adequately seed the IDGT, significant transfer tax savings can also be achieved. IDGTs also potentially allow a taxpayer to effectively transfer their interest in a closely held entity (or any other asset) to their grandchildren and further descendants while GST tax that may otherwise be imposed.

Before enactment of the regulations that are expected to limit the use of valuation discounts, the benefits of each of the above-described techniques can be magnified through the use of valuation discounts. Valuation is an important part of many of these techniques, and while discounts remain available, taxpayers may want to act now ensure they reduce their transfer taxes while passing more wealth to future generations.

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