The "Uncertain" Terrain of Estate and Tax Planning

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There are several variables which the estate planner must take into consideration in designing a plan which meets the client's objectives. Obtaining accurate and current financial information from the client, prioritizing the various goals of a client and providing access to liquidity and the appropriate amount of cash flow at all times is a multi-dimensional and dynamic structure to build. There are however certain axioms in life which no client can avoid, and which estate planning is built upon: death and taxes. Ironically, as "certain" as these two events may be, the laws and legislature surrounding these two events are far from being certain or defined.

This article will serve several purposes by venturing into the "uncertain" terrain of estate and tax planning, which a New York taxpayer should be aware of. The reader will first be given a brief historical perspective on the development of the New York State and Federal estate tax laws, as well as an understanding of the interplay between the two regimes over the past century. A synopsis of the current estate tax laws will be laid out to help us delineate the landscape within which the taxpayer presently stands. An analysis of the conflicts and concerns will be presented in order for the reader to gain a deeper understanding into the complexity underlying the current laws and how this affects one's estate and tax planning. Finally, various insights and alternative approaches are offered to the reader to help alert those who may need to take steps so they do not fall into the avoidable pitfalls or make certain choices which did not need to be made until now.

In order to properly give this topic the proper attention it deserves and to effectively provide the reader with new insights, a clearer understanding, as well as, a practical and beneficial perspective, this article will be broken into two parts and published in multiple issues. This first installment will provide a historical and economic context within which to relate to the New York State Executive Budget ("NYSEB"), as a reaction to the Economic Growth Tax Relief and Recovery Act ("EGTRRA"). The second installment will assess the new regime and provide an in depth analysis into how it works and in which ways clients and advisors must plan in consideration of it.

A HISTORICAL AND ECONOMIC BACKGROUND TO THE NEW YORK ESTATE TAX REGIME

Since January of 2014, the New York estate planning world has been abuzz with the implications and effects of the proposed changes Governor Andrew M. Cuomo announced would take place in just a few months' time with the NYSEB. The Governor had expressed that the intent behind the legislative changes was to deter New York residents from moving out of state towards the end of their lives by implementing more estate tax incentives. Paradoxical as it may seem, the legislature which was passed on April 1, 2014, just a few months later did not include all of the proposed changes, has little effect on some New York taxpayers, and what is worse, actually increased the estate and income tax liability for others.

As a backdrop to provide the context within which the most recent changes to the NYSEB are taking place, there are effectively three different eras to be mindful of. The first of these eras is the pre-EGTRRA era prior to 2001. The second era is the EGTRRA years, from 2001 to 2011, as the provisions of which were intended to sunset in 2011. The third and final era is the post-2011 years when many of the EGTRRA provisions were permanently adopted rather than "sunsetting" as planned. In addition, there are various phase-out periods which are very pertinent as well as the 1997 Taxpayer Relief Act ("TRA"), signed into law by President Bill Clinton. These will be discussed as well but the macro eras require the most attention.

Below is a chart which summarizes the Federal and State estate tax rates and exemptions during the three main eras which lead up to NYSEB.

NYSEB: A SECONDARY REACTION OR COMPRISE TO EGGTRA

To a large extent, the changes occurring during these three eras were reactions to EGTRRA. However, it would be more accurate to say that classify these changes as a secondary reaction; a "compromise," after the realizing the implications and ramifications of New York's initial reaction to EGGTRA, as it related to the New York taxpayer. This can be demonstrated by tracking the courses that New York State and Federal lawmakers have chartered over recent years to illustrate where these two courses have aligned and where they have deviated from each other. From an understanding of how and why New York initially digressed from the Federal law, we will see that though New York is purporting to have plotted a route back to the Federal gift and estate tax regime, in reality it might just be another ruse.

HISTORICAL BACKGROUND – HOW DID WE GET HERE?

1. Pre-EGGTRA Era

Before the 1997 Taxpayer Relief Act ("TRA") every state had an estate tax that was calculated by referencing the Federal government's maximum state death tax credit. Under this arrangement, for every dollar of state estate tax a person paid, he or she would receive a dollar-for-dollar credit against his or her federal estate tax. Without this arrangement, the taxpayer would owe the same amount of estate tax, except that it would be paid entirely to the federal government. Thus, this new arrangement "picked up" and redirected the amount of the state death tax credit from the federal government's revenue, rather than it coming directly from the taxpayer. Seen from this perspective, one might wonder why the federal government would

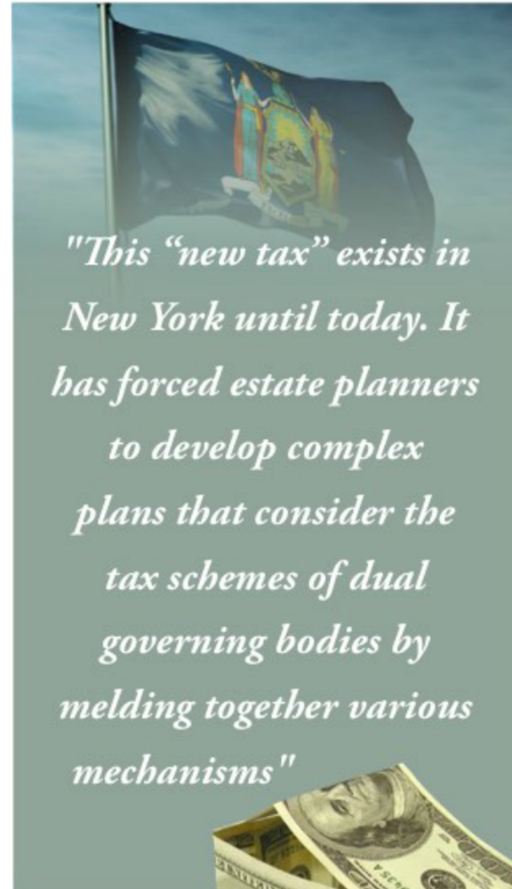
		Federal Estate Tax		New York State Estate Tax	
		Rate	Exemption	Rate	Exemption
Pre-EGTRRA		55%	600,000	16%*	$600,000*
EGTRRA (2001 – 2011)	2001-2009	Decreased to 45% by 2009	Increased to $1M in 2001 to 3.5M by 2009	16%	$1M
	2010	No Estate Tax	No Estate Tax	16%	$1M
	2011	55%	$600,000 by design	16%	$1M
Post-EGTRRA (Prior to 4/1/2014)		55%	Increased to current $5.34M	16%	$1M

* This is based on the maximum federal tax credit for state estate tax

permit the states to redirect a portion from their revenues. Based upon constitutional law, the state death tax credit can be reframed as more of an agreed upon "commission" of sorts, whereby the state governments were actually granting permission to the federal government to levy an estate tax on residents living within the state.

2. Transitioning to EGGTRA

By the time EGTRRA came around (four years after TRA) all states were still accounted for except for New York and five others who were already starting to drift away from the federal scheme. This decoupling was in anticipation of the federal exemption increasing from $600,000 to $1,000,000 by 2006. As its name implies, EGTRRA was intended to spur economic growth by lowering the estate tax rate and increasing the estate tax exemption.[1] These measures were purported to be a tax cut. As with all tax cuts, from where would the lost revenues be found? Farewell to the state death tax credit; the third salient provision of EGTRRA fully phased-out this credit by 2005.[2] While a deduction for state estate taxes paid was instituted in lieu of the state death tax credit, this meant that by 2005, the Federal government would no longer be sharing the estate tax revenues with the state governments. In other words, the tax cut shifted the burden to the states to make up for the lost revenues from the states' share of estate tax revenue. To illustrate, a three million dollar estate in 2003 would pay $145,250 less than a pre-EGTRRA estate of the same size in estate taxes. In other words, the federal government's "tax cut" meant that it would collect 6.1% less in 2003, while a pickup state would collect a full 50% less than it would have in 2001 from the same size estate.



3. EGGTRA & Decoupling

In response to this revelation, the remaining coupled states were left with three choices. Some remained pick-up states in that they kept their estate taxes linked to the federal governments. Though they remained pick-up states, by the end of 2004 there was effectively nothing left to "pick up" and they have essentially lost a revenue stream. Others partially decoupled by retaining the rates that existed prior to EGTRRA, but raising their exemption amounts in-line with the federal government's changes. New York, among other states, chose to react differently; this particular reaction was to fully decouple by affixing their estate tax scheme to the laws as they existed on July 22, 1998, prior to EGTRRA. In effect, this reaction entailed retaining the estate tax exemptions that are lower than the federal exemption, as well as, retaining the higher estate tax rates. The states in this last category, by fully decoupling have retained their revenue stream. In other words, rather than taking the hit themselves, the fully decoupled states, including New York, have parried the burden, shirked by the federal government, onto the individual taxpayer's estates. In fact, some consider this to be an entirely new tax.

4. Post-EGGTRA Era

This "new tax" exists in New York until today. It has forced estate planners to develop complex plans that consider the tax schemes of dual governing bodies by melding together various mechanisms such as Credit shelter trusts, marital trusts, and QTIP trusts. It has been tolerated in New York for years but its tolerance was due to the fact that EGTRRA was designed to sunset in 2011. But alas the main features of EGTRRA have been permanently adopted, which meant that without a state response, the new tax would also be permanent.

1) It gradually lowered the top marginal estate tax rates from 55% in 2001 to 45% in 2009 and it increased the taxpayer's lifetime exemption from $1,000,000 in 2001 to $3,500,000 in 2009 (see the chart above).

2) EGGTRA provided for an accelerated phase out of the state death tax credit over a period of four years (25% reduction per year) beginning in 2001, to being completely eliminated for deaths occurring in 2005 and after.

After the passing of the new Budget on March 31, 2014, the New York State exemption increases from the $1 million amount, as follows:

New York planners (and clients) have to pay attention to EGTRRA and the newest Executive Budget because without proper planning, it is possible that at a certain point, every dollar a New York resident earns will cost more money than the value brought in. In other words, instead of two steps forward and one step back, which is bad enough, a person may end up in a scenario where one step forward leaves one two steps back.

DECOUPLING TO RECOUPLING?

From a narrow perspective, the NYSEB appears as if there is a recoupling of the two regimes though notably at a significantly higher exemption amount than pre-EGTRRA. However, if anyone was optimistic about the New York increase of the exemption amount, their excitement surely dissipated when they calculated the ramifications of the new law in its entirety. The new Budget contains several provisions that protect New York State revenues despite the increased exemption amount. Among the most notable (and now infamous) elements that will be discussed in this article are the so-called estate tax "cliff", its phase-out of the exemption structure, and state portability (or lack thereof). In order to comprehend what it means for New York to have made these decisions however, a brief synopsis of the context within which this is all happening will not only be helpful, but will heighten both our appreciation and concern for what lies ahead of us.

THE RESPONSE OF NEW YORK STATE LEGISLATURE

As mentioned earlier, the NYSEB seems to be a compromise, a secondary reaction to the New York taxpayer's realization of being levied a new tax. Also mentioned earlier was how the main elements of the new budget - the increased exemption amount, its phase-out, and the decisions surrounding state portability- were purported to be a recoupling, a realignment of the charted courses, a return to pre-EGTRRA days, but that they were possibly just another ploy.

In the second installment we will see just how New York State is able to "afford" this exemption increase. By way of preview, it would seem that there are two traditions at play in this new legislation. The first is burden shifting, its third cameo in this article. And the other tradition, a bit more classic, is when all else fails, shift the taxes towards those with deeper pockets.

Though we tend to think of society as comprised of a trio of classes - the proletariat, the middle class, and the rich - in reality there are more nuanced subdivisions of these classes. Since New York State's deviation from the Federal scheme, there has been much planning required for the "moderately wealthy"; those whose estates exceed the New York State exemption but are still within the protection of the Federal exemption. These estates, even if they are only marginally over the state exemption, are sharing in the burden of this new tax. The new legislation, rather than eradicating the tax, has created a very crafty way to protect this particular middle class- by pushing the uber wealthy over a cliff. ■

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