WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Gift, Estate, & Trust Tax Law Changes in New York, Maryland and Minnesota.

MARKET TREND: States continue to make changes to their gift, estate and trust tax laws in an effort to increase revenue, in part by keeping wealthier residents from re-locating to low or no-estate tax jurisdictions and thus keeping more tax dollars in-state.

SYNOPSIS: Several states are contemplating modifications to their transfer tax laws, with New York, Maryland and Minnesota already passing changes. Perhaps most significantly, New York has (1) increased its estate tax exemption but phased-out its application for larger estates, (2) enacted a 3-year look back rule that adds gifts made within three years of death back into the New York gross estate, (3) eliminated the state income tax benefits associated with so-called DING and NING trusts, and (4) repealed its generation skipping transfer tax. The Maryland General Assembly has voted to gradually increase Maryland's state estate tax exemption to eventually match the federal estate tax exemption by 2019. Minnesota has increased its estate tax exemption to $2 million, enacted a state QTIP election, and retroactively repealed its recently enacted state gift tax.

TAKE AWAY: Given the extent and significance of New York's tax law changes, New York residents should promptly review their existing legacy and wealth transfer plans with their advisors and determine whether and what changes need to be made, particularly with regard to the phase-out of the New York estate tax exemption and the change in taxation of DING/NING trusts (which essentially takes effect on June 1st). Minnesota residents also may want to review whether they should modify their estate plans given the availability of a new state QTIP election and whether they are due a refund for any state gift taxes paid. Generally, as increases in state estate tax exemptions lessen the impact of state estate taxes for certain clients, the focus in planning will continue to shift from traditional estate tax plans to overall tax planning, including mitigation of the impact of federal and state income taxes.

PRIOR REPORTS: 14-12

Following a trend in changes to state transfer tax laws, New York, Maryland and Minnesota have recently passed changes to their estate, gift, and in the case of New York, trust income tax laws, which could significantly impact legacy planning for residents of these states. Some of the more notable changes and their potential practical implications are summarized below.

NEW YORK

As discussed in *WRMarketplace* No.14-12, New York's governor established the New York State Tax Reform and Fairness Commission in 2012 to review New York's tax laws and develop revenue neutral options for modifications. Based on the Commission's recommendations, the New York State Budget for 2014-2015, enacted effective as of April 1, 2014 ("**NYS Budget**"), makes several significant changes to New York's income and estate tax laws, the following of which will be of interest for legacy and insurance planning advisors:

- **Estate Tax Exemption Increased and Phased-Out**

Although the federal estate tax exemption for 2014 is $5,340,000,[1] New York has kept its estate tax exemption at $1,000,000 since February 2002 ("**NYS exemption**"). The NYS Budget, however, ***increases the NYS exemption over the next five years to eventually match the federal estate tax exemption*** as of January 1, 2019. But for larger New York estates, the NYS Budget offsets the benefits of a higher NYS exemption by rapidly phasing out its application for estates in excess of the exemption amount. ***The NYS exemption is fully phased-out for estates valued at more than 105% of the applicable exemption amount.***

The NYS exemption and full phase-out thresholds are as follows:

Decedents Dying On or After:	NYS Exemption	Estate Threshold for Full Phase-Out
April 1, 2014	$2,062,500	$2,165,625
April 1, 2015	$3,125,000	$3,281,250
April 1, 2016	$4,187,500	$4,396,875
April 1, 2017	$5,250,000	$5,512,500
January 1, 2019 and after	Indexed for inflation from 2010 (should match federal estate tax exemption)	105% of NYS exemption

The NYS exemption phase-out generates a tax "cliff," which can produce significant New York estate tax exposure for estates that minimally exceed the applicable threshold for full phase-out.

> ***Example:*** An unmarried New York resident dies on April 1, 2017, when the NYS exemption is $5,250,000 and the full phase-out threshold is $5,512,500. If the decedent has an estate valued at $5,512,500, just $262,500 over the NYS exemption, his estate will incur a New York estate tax of $452,300. This imposes an effective marginal New York estate tax rate of 172% on the $262,500 in excess of the NYS exemption. Note that if the same decedent died under prior New York law (*i.e.*, $1 million NYS exemption), his estimated New York estate tax would have been the same, $452,300.

Practical Implication: Although the increase in the NYS exemption is expected to exclude 90% of New York estates from New York estate tax, it leaves New York estate tax exposure unchanged for wealthier estates. Married New Yorkers can defer the impact of the cliff by designing the estate plan to take advantage of the NYS exemption at the first spouse's death (there is no portability of the NYS exemption between spouses, so leaving everything to the surviving spouse and relying solely on the marital deduction may push the value of his or her estate over the phase-out threshold). Depending on the estate's size, unmarried New Yorkers may want to consider using a formula designed to make a deductible charitable gift of the excess over the exemption or phase-out amount or by allowing estate beneficiaries to disclaim the appropriate amount to charity.

- **Gifts Added Back to New York Gross Estate**

New York, as with almost every other state (except Connecticut), does not impose a state gift tax. Thus, prior to April 1, 2014, New York residents could reduce or avoid New York's estate tax by making lifetime gifts, including just prior to death, resulting in a reduction in the size of their New York taxable estates and a corresponding loss of estate tax revenue.

To counter this potential revenue loss, the NYS Budget requires the value of gifts made within three years of a donor's date of death to be added back to the donor's New York gross estate (if the donor was a New York resident at the time of the gifts). The provision applies to ***gifts made on or after April 1, 2014 <u>but before January 1, 2019</u>.*** Note that it seems that the value of gifts of non-New York real or tangible personal property by a New York resident could be pulled back into the New York resident's estate under this provision, although New York law would not include the value of such items if owned by a New York decedent in determining the value of his or her New York gross estate. Thus, further clarification likely is needed on this issue.

Practical Implications: Until 2019, this change reduces the gift tax planning options for reducing New York estate tax exposure and effectively eliminates the ability of New Yorkers to make deathbed transfers for New York estate tax planning purposes. When combined with the phase out of the NYS exemption for estates in excess of the exemption, it could significantly increase the potential New York estate tax exposure for larger New York estates.

- **New York Tax Imposed on Exempt Resident Trusts, Including DING/NING Trusts**

A New York resident trust (*i.e.*, funded by an individual domiciled in New York when it became irrevocable or created under the will of a New York domiciliary) is exempt from New York income tax if (1) all trustees were domiciled outside New York, (2) all real and tangible trust property was located outside New York, <u>and</u> (3) all trust income and gain was derived from sources outside New York ("**NY Exempt Trust**").

Previously, incomplete gift trusts ("**ING trusts**") -- generally trusts created as non-grantor trusts for federal income tax purposes in a low or no income tax state like Delaware or Nevada -- could avoid New York income tax if structured as NY Exempt Trusts. If the ING trust distributed no taxable income to the grantor or beneficiaries, neither the trust nor the New York grantor or beneficiaries would pay New York taxes on the trust's income or gain from non-New York sources.

The NYS Budget, however, now treats ING trusts created by New York residents as grantor trusts for New York income tax purposes, essentially "decoupling" New York's income tax treatment of ING trusts from the federal income tax treatment. Effective as of January 1, 2014, ***all items of an ING trust's income, gain and loss will be includible in the trust grantor's New York gross income, as if the assets of the trust were owned directly by the grantor; provided that this tax treatment will <u>not apply to an ING trust liquidated before June 1, 2014</u>.***

In addition, for NY Exempt Trusts structured as completed gift trusts, New York will now subject New York beneficiaries to a "throwback tax" on trust distributions of income accumulated in prior years (subject to a credit for taxes paid in other jurisdictions). ***The tax on the New York beneficiary applies to distributions made on or after June 1, 2014 of income accumulated on or after January 1, 2014.*** The tax does not apply to distributions of trust income accumulated before a beneficiary is born, turns 21, or first becomes a New York resident.

Practical Implications: New York residents no longer can avoid exposure to New York income tax by transferring assets to an ING trust, which eliminates a powerful state income tax planning tool, particularly for New York residents with significant income generating portfolios or anticipated liquidity events with regard to highly-appreciated assets. As ING trusts will no longer offer any New York income tax benefits, ***New York residents will want to consider liquidating ING trusts they have established prior to June 1, 2014 to avoid inclusion of the trust's income in their New York gross income***.

A New York resident, however, can continue to make completed gifts to a NY Exempt Trust created as a federal non-grantor trust. While a New York beneficiary of the trust eventually may need to pay New York income taxes on distributions of accumulated income, the taxes are deferred until distribution and may be avoided if the beneficiary is not a New York resident at the time of distribution. These trusts, however, will have additional record-keeping and reporting burdens for New York beneficiaries, as well as issues in determining the application and amount of the throwback tax.

- **Generation-Skipping Transfer Tax Eliminated**

The NYS Budget repeals the New York generation-skipping transfer tax as of April 1, 2014.

MARYLAND

- **Estate Tax Exemption Increased**

The Maryland General Assembly has passed House Bill 739 / Senate Bill 602, which, beginning in 2015, gradually increases Maryland's estate tax exemption from the current $1 million to eventually match the federal estate tax exemption, as follows:

Year of Death	Maryland Estate Tax Exemption
2015	$1,500,000
2016	$2,000,000
2017	$3,000,000
2018	$4,000,000
2019	Tied to federal estate tax exemption

Practical Implications: With enactment, the re-coupling of Maryland's estate tax exemption with the federal exemption should allow for more streamlined estate planning. For example, the change should eventually eliminate the need to use a state "QTIP" trust to generate a state estate tax marital deduction for the amount by which the federal exemption exceeds the Maryland exemption. Note, however, that Maryland still imposes a separate state "inheritance" tax on testamentary transfers to certain individuals. Spouses, descendants (and their spouses), parents, grandparents, stepparents, stepchildren, and siblings are generally exempt from the Maryland inheritance tax, but a cousin or friend who receives a bequest, for example, could owe an inheritance tax of 10% on the value of the property received.

MINNESOTA

- **Estate Tax Rates Modified and Estate Tax Exemption Increased**

Recent legislation enacted in Minnesota revises the state's estate tax rates and increases its state estate tax exemption over the next four years to $2 million, as follows:

Year of Death:	Minnesota Estate Tax Exemption	Minnesota Estate Tax Rates
2014	$1,200,000	9% - 16%
2015	$1,400,000	10% - 16%
2016	$1,600,000	10% - 16%
2017	$1,800,000	10% - 16%
2018	$2,000,000	10% - 16%

Practical Implications: Since Minnesota does not re-couple its exemption with the federal estate tax exemption, additional planning still will be needed for married couples not to be subject to a Minnesota estate tax at the death of the first spouse on amounts in excess of the Minnesota exemption. As discussed below, Minnesota will now allow a state QTIP election, which can provide a state estate tax marital deduction for the amount by with the federal exemption exceeds the Minnesota exemption.

- **State QTIP Election Allowed**

Effective as of January 1, 2014, a Minnesota decedent's executor can make a state QTIP election for assets passing in a QTIP trust to the surviving spouse, even if a corresponding federal QTIP election is not made (which will generate a state estate marital tax deduction at the death of the first spouse but avoid a federal estate tax on the state QTIP election amount on the death of the surviving spouse if previously shielded by the predeceased spouse's federal estate tax exemption).

- **State Gift Tax Retroactively Repealed**

Less than one year after enacting a new state gift tax into law, Minnesota retroactively repealed the tax, which applied at a flat 10% rate on total lifetime gifts over $1 million made after June 30, 2013. Due to the retroactive repeal, Minnesota donors who made gifts after June 30, 2013 did not have to file a Minnesota gift tax return (due April 15, 2014), and any donor who filed and paid gift tax is entitled to a refund.

Minnesota, however, still retains a three-year look back rule, similar to New York's, in that gifts made within three years of a Minnesota donor's death will be added back to the donor's estate for purposes of determining the donor's estate tax liability.

TAKE AWAYS

- Given the extent and significance of New York's tax law changes, New York residents should promptly review their existing legacy and wealth transfer plans with their advisors and determine whether and what changes need to be made, particularly with regard to the phase-out of the New York estate tax exemption and the change in taxation of DING/NING trusts, the impact of which will become effective on June 1st.
- Minnesota residents also may want to review whether they should modify their estate plans given the availability of a new state QTIP election and whether they are due a refund for any state gift taxes paid.
- Generally, as increases in state estate tax exemptions lessen the impact of state estate taxes for certain clients, the focus in planning will continue to shift from traditional estate tax plans to overall tax planning, including mitigation of the impact of federal and state income taxes.

NOTES

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[1] Based on a $5,000,000 exemption amount that will be adjusted for inflation from January 1, 2012.

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