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2014 Estate Planning Update

To our Clients and Friends:

This letter will provide you with an overview of recent and proposed changes to the federal and New York estate and gift tax laws and suggest planning ideas that may be of interest to you to reduce your exposure to estate taxes.

Federal Estate Taxes

The American Taxpayer Relief Act of 2012 ("ATRA") made permanent the reunification of the federal estate and gift tax structures and permanently increased the estate, gift and generation-skipping transfer ("GST") tax exemption amounts to $5 million, subject to cost of living adjustments.

In 2014, the relevant exemption for all three federal transfer taxes has increased to $5,340,000. The federal tax rate that applies to transfers above the exemption amount is now a flat 40%. Married couples are eligible for two exemptions and therefore can potentially transfer up to $10,680,000 free of all three federal transfer taxes.

State Estate Taxes

New York, New Jersey and Connecticut all impose their own separate State estate taxes, and the State estate tax exemption amount varies in each state. Under current law, the New York, New Jersey and Connecticut State estate tax exemptions are $1 million, $675,000 and $2 million, respectively. In contrast, Florida imposes no State estate tax.

Thus, under current law, there is a substantial disconnect between the federal estate tax and the State estate taxes for residents of New York, New Jersey and Connecticut. To illustrate, a New York resident may transfer $5,340,000 to his or her heirs free of federal estate tax but only $1 million free of New York estate tax. The New York estate tax imposed on a taxable estate of $5,340,000 is approximately $431,000.

Estate Tax Planning for Married Couples

It has long been traditional estate planning for married couples to utilize "credit shelter trusts" to preserve the estate tax exemption of the first spouse to die. Previously, this was fairly standard estate planning practice for both federal and State estate tax purposes. A major change made by ATRA was to make permanent the portability of the federal estate tax exemption from a predeceased spouse to a surviving spouse. "Portability" essentially means that, to the extent the first spouse to die did not use his or her full federal estate tax exemption, the unused amount of the estate tax exemption passes over (is "portable") to the surviving spouse for federal estate and gift tax purposes. Thus, for example, if a husband utilizes none of his $5,340,000 federal estate tax exemption, the entire federal exemption passes to his surviving spouse under the portability rules, and the surviving spouse would then generally be able to pass $10,680,000 to their heirs free of federal estate or gift taxes. Portability does *not* apply, however, for State estate tax purposes. Thus, although the unused amount of a spouse's federal estate tax exemption passes to a surviving spouse for federal purposes, a surviving spouse is limited to his or her own State estate tax exemption for State estate tax purposes.

It should be noted that the federal estate tax exemption applicable to a surviving spouse at death may be affected by a number of factors, including the extent to which the surviving spouse utilizes his or her exemption during lifetime and whether the surviving spouse remarries and, if so, whether the surviving spouse survives the new spouse and, in such event, the federal estate tax exemption of the deceased second spouse.

As a result of the permanence of portability for federal estate tax purposes, it may now not be necessary to establish a credit shelter trust for the full federal estate tax exemption amount, depending upon the size of the estate. Instead, it may be preferable to limit the amount going into the credit shelter trust on the demise of the first spouse to the *lesser* of the federal or State estate tax exemption amount. To illustrate, in New York, for many married couples, it may now be good planning to limit the credit shelter trust amount to the New York $1 million estate tax exemption amount. This planning technique has the advantages of avoiding any State estate tax due on the death of the first spouse, allowing more to pass to the surviving spouse outright or in a marital deduction trust, and potentially enabling more assets to qualify for a step-up in basis for income tax purposes upon the demise of the second spouse.

In certain larger estates, however, it may be desirable to not limit the credit shelter trust amount to the State exemption. In other words, sheltering the federal exemption in the credit shelter trust might be preferable. If this were done, then, among other things, appreciated assets in the credit shelter trust would be sheltered from estate tax upon the demise of the surviving spouse, which may reduce the overall federal and State estate taxes. Other factors that need to be taken into account include the relevant capital gains and income tax rates applicable to the credit shelter trust and to the surviving spouse and the potential size of the surviving spouse's estate for federal estate tax purposes.

The takeaway is that, if you are a married couple residing in a state such as New York, New Jersey or Connecticut that imposes its own State estate tax at an exemption level different from the federal, it may be wise to review the provisions of your Wills to see what credit shelter trust provisions are in place and whether they are appropriate in light of the portability of the federal estate tax exemption.

New York State Proposed Estate Tax Law Changes

As part of his new budget, Governor Cuomo has proposed changes to the New York State estate and gift tax regime that would, in theory, increase the New York estate tax exemption amount to match the federal amount. The Governor's proposal is to increase the New York estate tax exemption amount to $5,250,000 ($90,000 less than the current federal estate tax exemption, but equal to the 2013 federal exemption amount) and have such amount be subject to cost of living increases. In addition, the Governor's proposal calls for decreasing the top State estate tax rate from 16% to 10%. If this proposal is enacted in its current form, New Yorkers with estates under $5,250,000 (and married couples with estates under $10,500,000) would not be subject to any federal or New York estate taxes.

The Governor's proposal also calls for closing or tightening up an existing estate tax planning "loophole". Under current law, taxable gifts made by an individual during lifetime are taken into account for purposes of calculating the federal estate tax but not for purposes of calculating the New York State estate tax. Therefore, wealthy individuals who make taxable gifts of up to the federal gift tax exemption amount ($5,340,000) can, under current law, reduce their eventual New York State estate taxes. The Governor's proposal calls for taking into account taxable gifts in calculating the New York State estate taxes in a manner similar to that of the federal estate tax calculation. This proposal would apply to taxable gifts made *after March 31, 2014*. Thus, for those with significant estates, there still may be time to reduce your exposure to eventual New York State estate taxes by making substantial taxable gifts *prior to April 1, 2014*.

Of course, it is uncertain whether the Governor's proposals will pass in the format proposed or be subject to changes by the New York State Legislature.

Federal Gift Tax

The gift tax annual exclusion amount (the maximum amount one may gift annually to a donee without having to file a gift tax return or utilize any portion of one's lifetime federal gift tax exemption amount) remains at $14,000 per donee or $28,000 for a married couple who elects to split gifts.

Trust Decanting

New York has recently amended its statute on "decanting" irrevocable trusts. "Decanting" essentially means transferring the assets of an irrevocable trust to a second trust pursuant to a power to invade principal provided to the trustee of the first irrevocable trust. New York subsequently liberalized its trust decanting statute in 2011 and further amended the statute in 2013. If you created a New York irrevocable trust that contains provisions that are no longer desirable, this is a good time to determine whether the decanting statute will allow those provisions to be changed.

Conclusion

The recent tax law changes present both challenges and opportunities. This is an opportune time to review your estate planning to determine whether there are changes you would like made to your Wills and other estate planning documents and whether you are taking full advantage of the opportunities presented by the increases in the federal estate, gift and GST exemption amounts and portability of the federal estate tax exemption amount. If you would like more information or wish to discuss your situation, please contact our estates partners, Stephen Krass or Lee Snow.

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To ensure compliance with requirements imposed by the Internal Revenue Service, we are required to inform you that any tax advice contained in this letter is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.