Danger: Cliff Ahead for New Yorkers

When the Federal Estate Tax exemption was doubled in 2018, most Americans were able to breathe a sigh of relief. The increase meant that, on a federal level, most married couples could pass over $20 million to their heirs without incurring a Federal Estate Tax. For New Yorkers, however, the news was not so promising. While New York has increased its exemption amount over the years (currently $6.110 million), there are severe repercussions for exceeding the exemption amount.

Background:

New York is one of twelve states (and the District of Columbia) that still imposes an estate tax on its residents. The other thirty-eight states have opted out of taxing the estates of their residents, making their residents only subject to a potential Federal Estate Tax.

Eleven of the twelve states that continue to levy an estate tax on their residents do so by tacking on a tax to that amount which exceeds the state's exemption. For example, let's assume Joe, a resident of Maine, dies with $7.010 million in assets. Maine's exemption is $6.010 million. According to Maine's estate tax laws, Joe will be taxed on the $1.0 million that exceeds the exemption amount at a rate of 8%. Therefore, his estate will pay $80,000 in Maine estate tax.

If Joe was a New York resident, however, the estate tax bill will be vastly different. Although the New York exemption is slightly more generous than Maine's exemption ($6.110 million instead of $6.010 million), Joe's estate is going to be slapped with a huge penalty for exceeding the exemption amount. In New York, once an estate exceeds 105% of the exemption amount ($6.4155 million), the entire estate (not just the overage) is subject to the estate tax. Therefore, New York would levy *a base tax of $522,800* on Joe's estate *plus* 12.8% tax on everything above $6.110 million ($115,200). The total New York estate tax bill assessed on Joe's estate would be $638,000 leaving his heirs to inherit $6.372 million.

If Joe had planned ahead, he could have kept his assets under the exemption amount and avoided a 71% tax on the amount that fell over New York's punitive "Estate Tax Cliff".

<u>Planning to Avoid the Cliff - _Give it Away!</u>

You can avoid being taxed on your assets at death by giving them away before you die or by giving assets to a charity upon death. There are myriad ways to give assets away, however, that allow the donor to maintain continued use and enjoyment.

<u>The Irrevocable Trust:</u> Let's assume that part of Joe's estate was a beach house in the Hamptons that was worth $3.0 million on his death. Joe purchased that home decades ago in a depressed market for $400,000 hoping the property was going to appreciate significantly. If Joe had put the property into an irrevocable trust for his children's benefit any time before the home was valued beyond $2.0 million, the remaining $1.0 million would have grown outside of his estate, and thereby allowed the entire estate to escape taxation. Using irrevocable trusts to insulate the market appreciation of an asset is a simple and sound way to mitigate exposure to the cliff while maintaining some control over the disposition of the assets.

<u>The Santa Clause:</u> Another gifting strategy is linked to making charitable gifts. Using Joe's estate as an example, his estate was $900,000 over the exemption amount, and $594,500 over the 105% total exemption allowance. Instead of Joe's Will requiring everything to be distributed to his children, it could have used a Santa Clause. Using a Santa Clause would have resulted in an overall savings of $43,500 to the estate and helped a cause that was important to Joe.

What is "The Santa Clause"? The Santa Clause is a distribution made in the Will to a charity of assets that are in excess of the New York exemption amount. The Santa Clause would allow the executor to determine what the heirs would inherit if no charitable gift was made and compare it to the amount they would inherit if the gift was made. In our example above, if Joe's estate gifted $594,500 to his favorite charity, the total the heirs would receive would be $6.4155 million (instead of $6.372 million that would be paid to them if no charitable bequest was made). It is a win for the heirs and the charity of Joe's choice. For estates that are just a few hundred thousand above the exemption amount, using this clause can result in even greater savings. The opposite is also true (i.e., as the estate valuation gets further from the exemption amount the Santa Clause offers less savings.) Nevertheless, this flexible clause gives your executor the ability to make the calculation at the time of death and obtain more for the heirs.

<u>Outright Gifts:</u> Instead of gifting to charities or a trust, New Yorkers can also take advantage of the fact that New York has no gift tax. Joe could gift $594,500 to his daughter during his life (reducing the amount of the gift only from his federal exemption amount) and still keep the $6.110 million New York exemption completely intact. In essence, Joe's entire estate would be exempt from estate taxes. In order for this strategy to work: 1) The gift has to be given at least three years before Joe's death; 2) Joe must be comfortable losing control over the asset; and 3) The Federal Exemption must be greater than the New York Exemption.

As in everything, the devil is in the details. It is important to consult with an experienced estate planning attorney before taking any of the steps delineated above to avoid mistakes and possible pitfalls. At Corrado Financial Group, our team can help you avoid the cliff with an estate plan that incorporates careful tax planning and portfolio management. Contact us to discuss how this may affect you and how we can address your specific needs.