Using New York Trusts For Asset Protection

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The federal estate tax exemption has soared to record heights – increasing to $5,430,000 for individuals dying in 2015. Logically, fewer estates will actually have to pay a federal estate tax as the federal estate tax exemption keeps increasing. This has shifted the focus of estate planning in many cases to implementing strategies that will help 1) minimize state estate taxes; 2) minimize current and future income taxes; and 3) protect assets from future and unexpected creditors.

The purpose of this article is to focus on using New York trusts as a means of protecting assets. The fact is, we live in a litigious society and the divorce rate remains high in the State of New York, especially since the passage of the no-fault divorce provisions that became effective on October 13, 2010. As a result, assets are now more vulnerable to general creditor claims as well as claims for child support and alimony. Certain trusts, however, can be used to potentially protect assets against the claims of the beneficiary’s creditors.

I. Self-Settled Revocable and Irrevocable Trusts.

In New York, an individual cannot protect assets from creditors by creating either a revocable trust or an irrevocable trust for his or her benefit.

New York law provides that where a creator retains the right to revoke the trust, he or she remains the absolute owner of the property so far as the rights of creditors are concerned. Therefore, a revocable trust is not an

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effective asset protection device because the creator retains a beneficial interest and has too much power and control over the trust assets. In fact, assets held in a revocable trust will be included in the creator’s estate at death because the creator can revoke or amend a revocable trust and will have complete access to the trust assets until death. In other words, if a creator has full access to the trust property, so too will a creditor, thereby allowing a creditor to levy against the trust assets to satisfy a claim.

The same result would occur if the creator established an irrevocable trust in New York for his or her benefit. Suppose, for example, an individual creates an irrevocable trust in New York for his or her benefit and names an “independent” individual or bank as trustee. Further assume the trustee has complete discretion to invade the trust income and principal for the benefit of the creator and the creator’s family. In this scenario, the trust assets would not be protected against creditor claims because EPTL Sec. 7-3.1 clearly provides that “A disposition in trust for the use of the creator is void against the existing or subsequent creditors of the creator”. This principle was first codified in 1787 and has been the firmly established law in New York State ever since.

To illustrate, in Vanderbilt Credit Corp v. Chase Manhattan Bank, a woman created an irrevocable trust in New York and named her brother as trustee. The trust provided that the trustee shall pay the net income to the creator and if the income was insufficient, the trustee had complete discretion to invade principal for her benefit. The trust included a spendthrift clause that prevented the creator from transferring her beneficial interest in the trust to a third party.

After the trust was funded, a judgment creditor brought an action seeking to attach the trust assets to satisfy a debt it had with the creator. The court referred to EPTL Sec. 7-3.1 and held that neither the income nor principal is exempt from the claims of the judgment creditor. The court noted that when a person creates a trust for his or her own benefit, the creditors can reach the maximum amount which the trustee could have paid to the beneficiary, even
though no discretionary principal invasions were previously made. In this case, the trustee had the power to invade the corpus to pay the entire principal to the creator/beneficiary and thus the creditor was allowed to reach the corpus to satisfy the debt. Furthermore, there was no need for the creditor to prove that the transfer to the trust was a fraudulent conveyance because it is against public policy to permit someone “to tie up her own property in such a way that she can still enjoy it but can prevent her creditors from reaching it.”

So in New York, assets held in both a revocable trust and a self-settled irrevocable trust will not be shielded from creditor claims of the creator. It is possible, however, for a third party to create a trust for someone else’s benefit so that part or possibly all of the trust assets are beyond the reach of the beneficiary’s creditors. These are referred to as “third party trusts”.

II. Third Party Trusts
A. Mandatory Income and Principal Distributions.

To illustrate, suppose mom creates an irrevocable trust for the benefit of her daughter. Daughter is to receive all the net income and at age 30, she is entitled to a distribution equal to one-half of the trust corpus and at age 40, she receives the balance outright. Daughter is currently 29 years old.

First, the trust assets should be beyond the reach of mom’s creditors assuming the transfer to the trust is not deemed a fraudulent conveyance. The more interesting question, however, is to what extent are the trust assets protected from the daughter’s creditors?

1. The income interest.

As a general rule, in New York State, all trust property held in a trust created by someone other than the beneficiary is beyond the reach of the beneficiary’s creditor. Furthermore, an income interest in a trust cannot be transferred or assigned unless the trust agreement specifically allows the income beneficiary to do so. This will generally prevent the income beneficiary...
from encumbering or pledging the interest to somebody else, including a creditor.

Notwithstanding this general prohibition, an income beneficiary is allowed to voluntarily transfer any amount of annual net income in excess of $10,000 to designated relatives, unless the instrument provides otherwise. Furthermore, an income beneficiary may transfer or assign any part or all of the income for the benefit of persons whom the beneficiary is legally obligated to support.

It is possible, however, that part of the income interest could be vulnerable to creditor claims. For example, a judgment creditor can attach up to 10% of the income that is available to the beneficiary as a means of satisfying a money judgment. Therefore, if a creditor is seeking to levy against an income interest held in a trust, it is important to determine whether the beneficiary is receiving either a mandatory or discretionary distribution of income. This will not only determine the amount of the potential attachment, but an income interest is not subject to attachment if the trustee has complete discretion whether or not income distributions will be made.

In Matter of Sands, a testamentary trust was created for the benefit of a nephew who owed a debt to a judgment creditor. The trust provided that the trustee was to pay the income directly to the nephew or apply the income for the benefit of the nephew or his descendants. The court had to determine what income was due and owing to the nephew so that the creditor could then attach a percentage of the income as allowed under prior law.

The court held that the nephew was entitled to all of the income, whether it was paid directly to him or applied for his family’s benefit. In essence, this meant that the nephew was entitled to a mandatory income distribution so that the judgment creditor was allowed to attach a percentage of the entire income interest in the trust.
New York law further specifies that if there is no valid direction to accumulate income, then the income in excess of the sum necessary for the education and support of the beneficiary is subject to the claims of the beneficiary’s creditor.\(^\text{15}\) Presumably, the creditor in this scenario would have the burden of proving how much income is not needed to support the beneficiary.

For better protection, consider drafting a trust with a “forfeiture provision” so that a beneficiary would forfeit his or her interest in the trust if the beneficiary’s creditor attempts to initiate a proceeding to enforce a money judgment.\(^\text{16}\) This would demonstrate the creator’s intent that the trust is strictly for the benefit of the beneficiary and that the beneficiary’s creditors should not have access to the trust fund.\(^\text{17}\)

2. **The principal interest.**

Interestingly, unlike the rules governing the assignment of an income interest, a beneficiary’s interest in trust principal may be freely assigned or transferred unless such assignment is specifically prohibited in the trust agreement.\(^\text{18}\) This is why many estate planners will maximize asset protection by adding a “spendthrift provision” that specifically prevents the beneficiary from assigning either the income or principal interest in the trust. This language is designed to shield the assets from the risk of creditors and protect the beneficiary against his or her own improvidence.

In the above example, the daughter receives an outright distribution of one-half the corpus at age 30 and the balance at age 40. These distributions are not discretionary which means the daughter has a legal right to these distributions when she reaches the indicated ages. This may be problematic if the daughter is not fiscally responsible to receive these distributions or if she is subject to creditor claims because a creditor can reach a principal distribution once it is paid to the beneficiary. Therefore, it may be advisable to add language to the trust that gives the trustee the power to “hold back” the distribution if the beneficiary is threatened by creditor claims or if it is simply in
the best interest of the beneficiary to delay or postpone the payment of an outright distribution. 19

B. Discretionary Trusts.

A discretionary trust created by someone other than the beneficiary offers the greatest protection for trust assets in New York. In a discretionary trust, the trustee has complete and absolute discretion to distribute the trust assets to or for the benefit of any beneficiary to the exclusion of others, or not to make a distribution at all. Stated differently, in a discretionary trust, the trustee has discretion regarding the amount to distribute, the timing of the distribution, whether to make any distributions at all, and which beneficiaries, if any, will receive a distribution. 20 A discretionary trust may provide that:

“So much, all, or none of the income and/or principal may be paid to any, all or none of the beneficiaries at any time or from time to time, as the trustee, in his or her sole, absolute and unfettered discretion may determine. “ 21

The goal is to make the beneficiary’s interest sufficiently tenuous in a discretionary trust so that the beneficiary cannot demand or enforce a distribution unless the trustee abused his or her discretion. 22 If drafted correctly, a beneficiary of a discretionary trust has no property rights in the trust because the beneficiary has no ability to compel distributions. In turn, the beneficiary’s creditor cannot demand payment from a discretionary trust because a creditor has no more right to the trust property than does the beneficiary. A creditor, however, may institute a proceeding to satisfy a money judgment once a beneficiary receives a distribution from a discretionary trust.

Although New York has no statute on point that defines the extent assets are protected in a discretionary trust, there is case law that provides “when there is a discretionary trust, the law is clear that a creditor of a beneficiary who is not the settlor, cannot compel the trustee to pay any part of the income or principal to the beneficiary”. 23 In fact, the IRS cannot attach a lien on the
delinquent taxpayer’s interest in a discretionary trust because the beneficiary does not have a property interest in the trust.  

What if the creator wanted a beneficiary to be the sole trustee of a trust whereby the trustee would have complete discretion to make distributions for his or her benefit? This would cause two problems. First, New York law provides that property covered by a presently exercisable general power of appointment would be subject to the creditor claims of the power holder (i.e. the trustee in this example) and it is immaterial whether this power was created by the power holder or some other person. Second, this would ordinarily give the trustee a general power of appointment, as defined under the Internal Revenue Code, because the trustee would have full discretion to make distributions to him or herself. The retention of this power will cause the trust property to be included in the trustee’s estate, thus possibly triggering transfer tax liability.

Interestingly, under New York law, a trustee of an irrevocable trust does not have the power to make discretionary distributions to himself or herself unless the power is limited to an ascertainable standard, such as health, education, maintenance or support, or the trust instrument makes express reference to the statute and provides otherwise. The purpose of the statute is to prevent the inadvertent inclusion of the trust property in the trustee’s taxable estate. Therefore, if someone creates a third party discretionary trust and names a beneficiary as sole trustee, the statute would require the court to appoint another trustee who would then have the power to make discretionary distributions to the beneficiary.

C. Discretionary Ascertainable Standard Trusts.

Consider a third party trust where the trustee would have complete discretion to make distributions limited to an ascertainable standard, such as the beneficiary’s health, education, maintenance, and support. One potential problem is that an ascertainable standard may not provide adequate creditor protection if a beneficiary is entitled to certain distributions. This creates a property right subjecting the trust assets to potential creditor claims.
To avoid this, the trustee should not be required or compelled to make a distribution to a particular beneficiary. In fact, it might be safer to name multiple potential beneficiaries allowing the trustee to have complete discretion to make or not make such distributions to any beneficiary, to the exclusion of others. This should protect the trust assets from the beneficiary’s creditor claims because the beneficiary no longer has an enforceable right to receive a distribution. In turn, a creditor could not compel the trustee to make a distribution to satisfy a claim.

As previously indicated, it is possible for a trustee of a third party trust to have the power to make distributions for his or her own health, education, maintenance and support. These powers may be broad, but they are not unlimited. The trustee would not have the complete power to independently decide whether to make a distribution for any reason. Instead, these distributions are limited to certain categories – namely health, education, maintenance or support. Without full discretion, the trustee does not have a general power of appointment over the trust property so that the trust assets will not be included in the trustee’s taxable estate at death.

The question then becomes, “Are the trust assets subject to the creditor claims of the trustee/beneficiary because the beneficiary is also acting as trustee?” Ordinarily, New York law provides that property covered by a power that is exercisable solely for the trustee/beneficiary’s support, maintenance, health and education is not subject to claims of the trustee/beneficiary’s creditors. An issue could arise, however, if the trust instrument requires a trustee to make a certain distribution but the trustee abuses his or her discretion and refuses to do so. It would appear that the creditor could then seek court relief to force the trustee to make the distribution in order to satisfy the claim.

D. Third Party Supplemental Needs Trusts.

A supplemental needs trust is a variation of a discretionary trust which is created for a disabled beneficiary and is designed to supplement, not impair or
diminish, governmental benefits, such as Medicaid. A third party supplemental trust is simply a trust created by a family member or someone other than the beneficiary. Bear in mind, however, that the beneficiary’s spouse can create a testamentary supplemental needs trust for the benefit of a disabled spouse, but not a lifetime supplemental needs trust.

New York recognized the third party supplemental needs trust in Matter of Escher, where father created a discretionary trust for the benefit of his disabled daughter who ultimately ended up living in a psychiatric center. The trust provided that the principal was only to be invaded for health related emergencies. The State argued that the trustee abused his discretion by not invading the entire corpus to help pay for her cost of care. The Court of Appeals affirmed the Surrogate’s decision that the assets were protected against the State’s claim because the requested invasion was contrary to the father’s intent. Thus, Matter of Escher stands for the proposition that if drafted correctly, the assets in a third party supplemental needs trust cannot be used to reimburse the State for certain governmental programs.

In 1993, Matter of Escher was codified under EPTL Sec. 7-1.12. This statute defines a supplemental needs trust as a discretionary trust established for the benefit of a person with a “severe and chronic or persistent” disability. The trust document should prohibit the trustee from expending or distributing trust assets which may impair the beneficiary’s right to receive certain governmental benefits and to ensure that the beneficiary’s interest is not deemed an available resource for the purposes of Medicaid.

The statute includes sample language that may (but is not required) to be used to qualify as a supplemental needs trust. Although the statutory language need not be followed, a supplemental needs trust should provide evidence of the creator’s intent to supplement, not supplant or diminish, governmental benefits or assistance which the beneficiary may already be receiving or may be eligible to receive in the future.
E. **Support Trusts.**

A support trust typically indicates that the trustee “shall” or “may” make distributions for the beneficiary’s health, education maintenance and support. In turn, only so much of the trust income or principal will be paid as is needed to support a beneficiary in these categories. Many times, the language that creates a support trust is mandatory so that the trustee “shall” make or is required to make certain distributions. If the direction is mandatory, then the trustee only has discretion as to the timing, or manner or size of the distribution – not whether a distribution should in fact be made.  

Such was the case in *Magavern v. United States* 33, where mom created a testamentary trust for the benefit of the family group that consisted of her husband, her son and her son’s children and grandchildren. The trust provided that the trustee “shall pay … whatever part or all of the net income or principal… to the individual members of said family group.” The son was deficient in his federal tax payments and the IRS was seeking to satisfy an outstanding tax assessment by levying the son’s interest in his mother’s testamentary trust.

The Surrogate initially held that based on the terms of the trust, the trustee has discretion to withhold distributions and as a consequence, the son had no property rights in the trust and the tax levy was denied. Meanwhile, the trustee commenced an action in Federal District Court seeking to enjoin the enforcement of the levy.

The District Court held that it was not bound by the Surrogate’s decision and determined that the mandatory language in the trust required the trustee to pay at least some income to each beneficiary, including the son. The US Court of Appeals affirmed the District Court’s decision.

The US Court of Appeals held that the trustee was bound to distribute some income to each of the beneficiaries for their “comfortable support,
maintenance and or education”. In fact, the beneficiary had a property right subject to attachment because under New York law, a beneficiary could enforce this distribution right of the trust if the trustee refused to make any distributions. Therefore, the taxpayer had an identifiable property interest that was subject to the federal tax lien. The court also concluded that the IRS had the right to reach the trust assets because the payment of taxes is to be included within the definition of “support”.

F. Alimony and Child Support Claims.

Can a trust be drafted so that the trust assets are beyond the reach of the beneficiary’s alimony or child support claims?

Although property held in a third party trust is generally beyond the reach of the beneficiary’s creditors, New York law specifically provides that it shall not impair any rights an individual has under a qualified domestic relations order or under a court order for the payment of “support, alimony or maintenance”.

This issue was raised in Matter of Knauth, where mom created a spendthrift trust and the son was to receive the entire income interest in the trust. The son voluntarily assigned a portion of his income interest to his ex-wife, even though the instrument stated that the trust property was “free and clear from the control of (his) debts”. The funds were used to support his ex-wife and children. The Court of Appeals held that such an assignment was valid and noted that other courts have gone so far as to uphold a “wife’s right to an involuntary transfer” of a husband’s future income interest in a spendthrift trust when the funds are used for spousal support (emphasis added).

Other cases have forced a beneficiary to involuntarily transfer an interest in a trust to help pay child support. In Matter of Chusid, father created a spendthrift trust for the benefit of his son. The trustee had complete discretion to distribute the income to his son and his children. The son also was given the
absolute cumulative right to withdraw 5% of the principal each year, commencing when he reached age 35. At the time of the court proceeding, son was 42 years old and therefore entitled to 35% of the trust principal (5% x 7 years). The son would receive this distribution once the trust is funded and the assets are liquidated.

The son’s estranged wife brought a proceeding requesting the court to direct the trustees to pay her a portion of the income and the vested principal for the support of the three infant children. The court agreed and ordered the trustee to pay two-thirds of the income and principal to the spouse for child support whenever these payments are made. Although the unvested principal was not subject to the attachment, the court noted that “(p)ublic policy has recognized the right of a wife and dependent children to reach the income and on occasion the principal of a spendthrift trust”. Arguably, the unvested principal in a trust could be subject to alimony or support claims because there is nothing in the statute that exclusively limits the recovery to trust income or vested principal.

A trust is frequently created to preserve wealth within the family lineage. One option is for a parent to create a trust providing the trustee with complete discretion to make distributions to the children and their descendants. The trust might state, however, that the property is not subject to alimony claims. Here, the funds are available for the benefit of the family, including satisfying child support claims. But are the proceeds beyond the reach of alimony claims?

On one hand, an argument can be made that a court should adhere to the trust language exempting the trust property from alimony claims because a creator of a trust should have the right to dispose of the trust property as he or she sees fit, including not benefiting the descendants at all. In fact, in this example, the trust funds can be used for child support as a means of protecting the dependent children. Interestingly, the court in Matter of Chusid noted that the public policy is stronger protecting the rights of dependent children (particularly where they may become a public charge) when compared to protecting spousal rights. Furthermore, if one of the children is delinquent in
paying alimony, that would be the beneficiary’s obligation – not that of the trust creator. Finally, each spouse voluntarily enters a relationship with the possible understanding that the recovery of alimony claims may be limited against assets held in a spendthrift trust. Certainly this logic would not apply to minor children who are born into the family and have no choice in the matter.

On the other hand, although the general rule under New York law is that assets held in a third party trust are protected from the claims of the beneficiary’s creditors, the law shall not impair the rights an individual has under a court order for the payment of alimony. Therefore, given the wording of the statute, there is certainly no guarantee that a court will honor this language or even limit the recovery for alimony, but at least it clarifies the creator’s intent.  

**Conclusion.**

A self-settled revocable or irrevocable trust offers no creditor protection for the creator. A trust created by someone for the benefit of another that requires mandatory income or principal distributions offers a great deal of protection against creditor claims, but up to 10% of the income and income not needed for the beneficiary’s support could be vulnerable. The third party discretionary trust offers the greatest protection of trust assets in New York, as does a third party trust that gives the trustee the complete discretion to make distributions for the beneficiary’s health, education, maintenance and support. Additionally, if drafted correctly, the assets in a third party supplemental needs trust will not be deemed an available resources for Medicaid purposes. A “support trust”, however, could be vulnerable to creditor claims, especially if distributions are required to be made under certain circumstances. Finally, at the very least, a beneficiary’s interest in income and vested principal may be reachable to satisfy alimony and child support claims.

U.S. Bank and its representation do not provide tax or legal advice. Each individual’s tax and financial situation is unique. Individuals should consult their tax and/or legal advisor for advice and information concerning their particular situation.
Endnotes

1. Estates Powers and Trust 10-10.6 (EPTL).
2. See Internal Revenue Code 2038 and 2036 (IRC).
5. Id at 546.
6. There are currently 15 states that allow for the creation of the self-settled asset protection trust. If drafted correctly, the trust assets will be beyond the reach of most of the beneficiary’s creditors, even though the beneficiary created the trust for his or her own benefit. Further discussion of these trusts is beyond the scope of this article.
7. See Article 10 of the Debtor and Creditor Law.
8. Civil Practice Law & Rules 5205 (c) (CPLR).
9. EPTL 7-1.5(a).
10. EPTL 7-1.5(b).
11. EPTL 7-1.5(d).
12. CPLR 5205(d).
13. 270 NY 281 (1936).
15. EPTL 7-3.4. See also In re Vogel, 16 B.R. 670 (US Bankruptcy Ct., S.D. Florida, 1982).
21. Id at 10.
25. EPTL 10-7.2.
26. IRC 2041.
27. EPTL 10-10.1.
29. IRC 2041(b)(1)(A).
30. EPTL 10-7.2.
32. See Sandoval, Drafting Trusts for Maximum Asset Protection from Creditors, NAE LA Quarterly, Fall 2004.
34. See also US v. Taylor, 254 F. Supp. 752 (N.D. Cal., 1986).
35. See TAM 0017665.
36. CPLR 5205(c) 4.
38. Id at 264.
40. Id at 464.
41. Id at 465.
Issues with the New Trusts and Estates Tax Law in New York

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New legislation became effective April 1, 2014 that has had a huge impact on the taxation of trusts and estates in New York. The new law raises the basic exclusion amount (i.e. the amount a New York resident can pass free of New York estate tax) from $1 million to $2,062,500 for individuals dying between April 1, 2014 and March 31, 2015. Thereafter, the New York basic exclusion amount will continue to rise in three increments over the next two years and eight months, until it equals the federal estate tax exemption on January 1, 2019. On March 29, 2015, Governor Cuomo and New York lawmakers announced that an agreement was reached on the Executive Budget that clarifies some provisions of this new legislation, but several quirks and perceived inequities still remain.

Add-back Gifts. New York still does not have a gift tax but effective April 1, 2014, the taxable estate will include taxable gifts that were made by a New York resident within three years of date of death. This “add-back” provision will apply to gifts made between April 1, 2014 and December 31, 2018. Recent amendments further clarify that the gift add-back provisions will not apply to individuals dying after January 1, 2019.

On August 25, 2014, the New York State Department of Taxation and Finance issued a Technical Memorandum (TSB-M-14 (6)M) indicating that gifts of real or tangible property located outside New York will not be added back to a resident’s gross estate because such property would be not be subject to New York estate tax if it was owned by a New York resident at the time of death.
There is also a question of whether the New York estate tax paid as a result of the inclusion of the add-back gifts can be taken as a deduction when calculating the federal estate tax. Section 2058 of the Internal Revenue Code states that state estate taxes can be deducted if it is paid on property that is included in the federal gross estate. Arguably, add-back gifts are not part of the federal gross estate and therefore estate taxes paid on them are not deductible. Unfortunately, an amendment will not work here because New York law cannot expand the definition of what is included in the federal gross estate.

**The Estate Tax Rate Schedule.** The New York estate tax rate schedule can be found in Section 952(b) of the Tax Law. The statute initially specified that the schedule applies to those dying “on or after April 1, 2014 and before April 1, 2015” but there was no indication how the tax is calculated thereafter. This legislation was recently amended, however, to clarify that the estate tax rate schedule shall apply to those individuals dying on or after April 1, 2014.

**Paying the New York Estate Tax for Taxable Estates that Slightly Exceed the Exemption could be Foolhardy.** A New York estate tax is paid if the taxable estate exceeds the basic exclusion amount. In fact, the New York estate tax exemption completely fades away once the taxable estate exceeds 105% of the basic exclusion amount, whereupon the tax is the same as imposed under prior legislation. The table below shows the basic exclusion amount and the full phase-out amount from April 1, 2014 through January 1, 2019.

<table>
<thead>
<tr>
<th>Date of Death</th>
<th>Basic Exclusion Amount</th>
<th>Full Phase-Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1, 2014 to March 31, 2015</td>
<td>$2,062,500</td>
<td>$2,165,625</td>
</tr>
<tr>
<td>April 1, 2015 to March 31, 2016</td>
<td>$3,125,000</td>
<td>$3,281,250</td>
</tr>
<tr>
<td>April 1, 2016 to March 31, 2017</td>
<td>$4,187,000</td>
<td>$4,396,875</td>
</tr>
<tr>
<td>April 1, 2017 to Dec. 31, 2018</td>
<td>$5,250,000</td>
<td>$5,512,500</td>
</tr>
<tr>
<td>January 1, 2019 and thereafter</td>
<td>Fed.Exemption Amount</td>
<td>5% over Fed. Exemption</td>
</tr>
</tbody>
</table>
In essence, a credit is allowed if the taxable estate exceeds the basic exclusion amount by less than 5%. The applicable credit amount is determined by referring to a formula that is contained in Section 952(c) of the Tax Law. Once calculated, this credit will be subtracted from the “gross” estate tax and the difference is the amount of New York estate tax owed. Basically, the credit is the amount of the New York estate tax that would have been paid if the size of the estate amounted to the following fraction:

\[
\text{basic exclusion amount} \times 1 - \left( \frac{\text{taxable estate} - \text{basic exclusion amount}}{5\% \text{ of the basic exclusion amount}} \right)
\]

To illustrate, assume a decedent died on May 1, 2014 with a New York taxable estate of $2,112,500, which exceeds the basic exclusion amount by $50,000. To determine the applicable credit amount in this example, first calculate the New York estate tax owed on the size of an estate represented by the following fraction:

\[
$2,062,500 \times 1 - \frac{$50,000}{50,000} = $1,062,498.90
\]

$103,125

The New York estate tax owed on a $1,062,498.90 (ignoring the exemption) is $43,737.44, as determined by referring to the tax rate schedule in Section 952(b) of the Tax Law. Therefore, the applicable credit amount in this example would be $43,737.44.

Next, refer again to the tax rate schedule in Section 952(b) of the Tax Law to determine the New York “gross” estate tax owed on a $2,112,500 taxable estate, which is $107,800. Finally, subtract the applicable credit amount of $43,737.44 from $107,800, and the New York estate tax owed in this example is $64,062.56.

Note, the $50,000 excess above the basic exclusion amount is subject to an estate tax of $64,062.56, leaving a net estate of $2,048,737.44. If the
$50,000 excess in this example is simply left to charity, the net estate would have been $2,062,500, which is $14,062.56 more than if the estate tax was paid. In fact, for decedents dying between April 1, 2014 and March 31, 2015, the estate tax paid will exceed the excess over the basic exclusion amount until the taxable estate exceeds $2,175,325. Stated differently, if the taxable estate is between $2,062,501 and $2,175,325, the excess over the basic exclusion amount should go to charity in order to guarantee a net estate of $2,062,500. Otherwise, if you pay the estate tax, the net estate will be less than $2,062,500. Note the examples in the following table:

<table>
<thead>
<tr>
<th>NY Taxable Estate</th>
<th>Excess Over Exclusion</th>
<th>NY Estate Tax</th>
<th>Assets Remaining</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,062,500</td>
<td>$0</td>
<td>$0</td>
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</tr>
<tr>
<td>$2,175,500</td>
<td>$113,000</td>
<td>$112,840</td>
<td>$2,062,660</td>
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In fact, this will worsen as the basic exclusion amount increases because the excess over the basic exclusion amount will be subject to higher marginal tax rates in the future. Therefore, consider adding the following clause in a will to avoid this dilemma:
If the New York taxable estate generates a New York estate tax that is larger than the excess over the basic exclusion amount, then such excess amount shall go to ABC Charity.

Clearly, this does not represent good tax policy. The statute should be revised so that the estate tax paid will never exceed the excess amount over the basic exclusion amount. One option is to modify the law so that the New York estate tax is either 50% of the excess over the basic exclusion amount or the tax determined by referring to the tax rate schedule in Section 952(b) of the Tax Law—whichever is less. That way, the tax payment can never be more than 50% of the excess over the basic exclusion amount and for individuals dying between April 1, 2014 and March 31, 2015, the tax rate schedule will start generating a lower result once the taxable estate exceeds approximately $2,310,000.

**Portability Should be Allowed.** Federal estate tax law allows the surviving spouse to take advantage of the first spouse’s unused estate tax exemption. This concept is known as portability. New York does not recognize portability, which creates a disparity between the federal and New York estate tax laws. New York should consider recognizing portability, especially by January 1, 2019, when the New York basic exclusion amount will match the federal exemption.

**The New York QTIP Trust.** The new law clarifies that a NY QTIP election can be made when no federal estate tax return is required to be filed. This would allow an estate to take advantage of the marital deduction for New York estate tax purposes, but not federal. This would apply when the estate is small enough so that no federal estate tax return is required to be filed.

The problem, however, is that a federal estate tax return must be filed if the surviving spouse wants to take advantage of portability for federal estate tax purposes. In this instance, the new law clarifies that if the QTIP election was not made on the federal return, then it cannot be taken on the New York return. This seems to be a harsh result and can easily be corrected by the appropriate amendment.
Exempt Resident Trust. Generally, if a New York resident establishes a trust in New York, the accumulated income of the trust will be subject to New York income taxes. For example, suppose a New York resident establishes an irrevocable trust in New York City for the benefit of his or her children. Further assume the trust is funded with marketable securities that have appreciated in value. Suppose in 2014, the trust sold a marketable security that generated a capital gain of $1 million. If the proceeds remain in the trust, not only would the trust have to pay a 20% federal capital gains tax and a Medicare surtax of 3.8%, but the trust would have to pay New York State and New York City income tax at a combined maximum rate of 12.696%.

A New York resident, however, can create a trust that avoids New York income taxes if 1) all the property is located and administered outside New York; 2) all the trustees are not domiciled in New York; and 3) the trust does not generate any New York source income. This is known as an exempt resident trust.

Now assume the same trust was created in Delaware or decanted to Delaware. Delaware does not impose a state income tax on the trust as long as none of the trust beneficiaries reside in Delaware. Ordinarily, if the same security was sold and the proceeds were retained in the trust, the trust would still pay federal income taxes but the New York State and New York City income taxes would be avoided. Then if the proceeds were distributed to New York beneficiaries three years after the sale, the beneficiaries would receive the funds without being taxed on the accumulated income.

The new law now imposes a “throwback” tax when New York beneficiaries of an exempt resident trust receive distributions of accumulated trust income. The new law applies to tax years beginning January 1, 2014. The statute also provides that the “throwback” tax will not apply if distributions are made prior to June 1, 2014. This part of the statute is meaningless because if a trust makes a distribution prior to June 1, 2014, the accumulated income would not be passed out because the statute does not apply to prior tax years. Furthermore, if the trust earned income between January 1, 2014 and June 1,
2014, that income will be passed out and taxed to the beneficiaries anyway – whether governed by the old or new law.

The initial draft of the legislation provided that the “throwback” tax applied to any accumulated income that was previously undistributed but this tax would not be triggered if the distribution was made prior to June 1, 2014. This language was not included in the final version of the statute, thereby making the June 1st date is superfluous because the “throwback” tax only applies to tax years after January 1, 2014.

Although these provisions will lead to unexpected tax consequences for pre-existing trusts, there are still certain advantages to accumulating income in an exempt resident trust where distributions are made to New York beneficiaries in later years.

First, only accumulated income that would be allocated to distributable net income (“DNI”) will be subject to the “throwback” tax. DNI is the income earned by the trust which may be distributed to beneficiaries. Typically, items of ordinary income, such as dividends and interest (taxable and tax-exempt) are included in DNI, but capital gains are not to the extent the gain was allocated to principal. This means if the trust is structured correctly, an exempt resident trust could avoid paying New York income taxes when capital gains are recognized, even if these proceeds are distributed to New York beneficiaries in subsequent tax years. Additionally, unlike accumulated distributions in a foreign non-grantor trust, the throwback tax in New York does not impose an interest charge. Therefore, the exempt resident trust can still be used to avoid state income tax on capital gains and defer New York income tax on the accumulated ordinary income until it is actually distributed to the New York beneficiaries.

Ding Dong the DING is Dead. The new law also puts an end to the “ING” trusts created by New York donors. “ING” is short for incomplete gift, non-grantor trust. Such a trust can be created where the grantor does not give up enough control so that the transfer is treated as an incomplete gift for gift
tax purposes, but the grantor gives up enough control so that the trust is treated as a separate entity (i.e. a non-grantor trust) for income tax purposes. If this trust is created in Delaware, it is known as a “DING” trust.

Once the trust was created, it was possible for the trust to sell an asset and avoid state fiduciary income taxes because the trust was administered in a state that did not impose a state income tax on accumulated income held in a trust. Then it was possible for the donor to receive a discretionary distribution from the trust in a later year, without any state income tax consequences.

This is no longer the case for New York grantors. Going forward, if a New York Grantor creates an “ING” trust, it shall be treated as a grantor trust for New York income tax purposes. That means that once the asset is sold in the trust, the grantor must report that sale and pay the relevant New York income taxes on his or her personal income tax return.

This creates a disparity on how an “ING” trust is treated for federal and New York income tax purposes. If an “ING” trust is treated as a separate entity for federal income tax purposes but a grantor trust for New York income tax purposes, what happens when an asset is sold? The federal capital gain is reported on the US fiduciary return but the New York capital gain is reported on the grantor’s New York individual tax return. This would be unduly burdensome for trustees, New York grantors and those who practice in this area. Maybe the better approach is not to have the “ING” trust qualify as an exempt resident trust. Instead, the “ING” trust could be treated as a separate entity for federal and New York income tax purposes so that the trust (and not the grantor) is now subject to New York income taxation.

**Conclusion.** The good news is that the new law raises the New York basic exclusion amount from $1 million to $2,062,500 and it will eventually match the federal exemption by January 1, 2019. Clearly, those estates under the new basic exclusion amounts will benefit from this new legislation. But the cliff portion of the tax for those estates between 100% - 105% of the basic exclusion amount is unfair and should be revised. Furthermore, technical
amendments should be added, where needed, to help clarify this new body of law. Finally, substantive changes, especially concerning portability and the ING trust, should be made so that the federal and New York estate and trust tax laws are better integrated.

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