The New York Times | http://nyti.ms/1ixw5ZZ

YOUR MONEY

Live Longer and Heirs Will Prosper in New York

APRIL 18, 2014

Wealth Matters

By PAUL SULLIVAN

DYING is going to have lower tax consequences in New York — if you can wait five to eight years. But in the meantime, the new estate and gift tax law that went into effect on April 1 is going to create enormously complex financial planning problems for all sorts of people.

Gov. Andrew M. Cuomo's stated goal at the beginning of the year was to eliminate the incentives for wealthy New Yorkers to "move to die." The idea was to dissuade rich retirees from leaving for places like Florida not just for warmth and sunshine but because estate and gift taxes are much lower there.

But given the political realities in Albany, he only partly succeeded. Changes in the law will be phased in gradually, meaning the details will be different every year until 2019, and a seemingly small miscalculation could have major tax consequences.

Before the new law was passed, people in New York whose estates were valued at $1 million or less were exempt from estate taxes, but estates of that size are fairly common in New York. That meant a disproportionate number of people were hit by the state tax who would not have been subject to the federal estate tax, which has a much higher exemption.

Furthermore, the top rate in New York is a whopping 16 percent — much higher than the average across the country. While the new law will gradually raise the exemption level each year until 2019, it leaves the top rate at 16 percent.

If all goes as planned, New York will be in a better position on estate and gift taxes than its neighbors New Jersey and Connecticut by 2019. But the state will still be far behind states like Florida and Arizona that have no state estate and gift taxes — and better winter weather.

Here are some considerations for the affluent and the rich to consider when it comes to dying and making taxable gifts in New York.

Middle class confusion: The old exemption was $1 million a person; the new one is $2,062,500. It is set to rise by $1,062,500 each April 1 until 2017 — when it will be $5.25 million — until it matches whatever the federal exemption is on Jan. 1, 2019, close to $6 million.

For all the people under that threshold, this is good, and more people will come under that exemption each year. The bad news is the exemption is structured like "The Price Is Right": If you go one penny over, you lose.

The law is written so that the state estate tax is applied gradually once the amount of the estate exceeds the exemption. You begin to lose the exemption amount until the estate exceeds the exemption by 5 percent and New York taxes you on the entire estate as if there was no exemption. It sounds fair, but it isn't logical.

According to calculations run by John D. Dadakis, a partner at the law firm Holland & Knight, here's how that works:

If the estate is worth $1,000 more than the current exemption, the tax bill is $1,077. If it is $100,000 over, the bill is $109,729.50. At an estate valued at $2,165,625 the person would owe $112,050.

Paul Hyl, a lawyer in Melville, N.Y., noted that to incur a federal estate tax of $112,050 in Florida (which, you will recall, has no state estate tax), the person would need a much larger estate of $5,620,125.

And on the federal level, where every individual estate has an exemption this year of $5.34 million, the math for New York residents gets screwier still. Mr. Dadakis pointed out that someone with an estate of $5,830,455 would owe no federal estate tax but would pay a New York tax of $490,455. The reason is that the state estate tax gets deducted from the estate. However, for someone who is not a New York resident — and living in a state where only the federal tax applies — the bill would be less: $196,182.

In short, it's complex, which is never good.

"Complexity obscures understanding," said Mark W. Everson, who served as commissioner of the Internal Revenue Service from 2003 until 2007, a time when the federal estate tax was going through a similar period of change. "You can cause confusion among the taxpayer and that can lead to noncompliance or cost the taxpayer more. On the other hand, complexity gives people incentives to bend the rules, and they seem to comply but they're not consistent with the laws."

On a practical level, it means that middle- and upper-middle-class people who would not have to do any federal estate planning will have to do some in New York, at least over the next five years.

One solution for estates that are close to the exemption would be to give a charity any money above the exemption that would incur a state estate tax bill, said Chi-Yu Liang, a partner at the law firm Withers Bergman.

Another solution for married couples is to use the formula clauses that were part of estate plans when the federal exemption was rising each year. These clauses are written so that the maximum exemption amount is put into a credit shelter trust with the rest passing tax-free to the surviving spouse.

UPPER-CLASS DISILLUSIONMENT For the wealthiest people, who could save millions of dollars by moving out of New York, there has been no real change. Sharon L. Klein, managing director of family office services and wealth strategies at Wilmington Trust, said for the wealthiest it was the top rate, not the exemption, that matters.

Governor Cuomo had pushed for that rate to be lowered to 10 percent from 16 percent. But he lost that battle, even though the very wealthy was the group most likely to move.

"Those are exactly the kind of people you want to incentivize to stay," Ms. Klein said. "You don't really care about the moderately wealthy."

The very wealthy who stay in New York will spend their money and pay a lot in property, income, sales and even gas tax. If they leave to avoid an onerous estate tax, the state loses everything.

Mitchell A. Drossman, U.S. Trust's national director of wealth planning strategies, pointed out that an estate of $8,089,000 in New York would pay the same amounts in federal and New York taxes — $785,000 — even though the federal rate is 40 percent and the state rate on that amount is 13.6 percent. This is because of the higher federal exemption.

Yet the current New York tax rates expire on March 31, 2015. Presumably this will give the governor and Legislature time to change the rates or make them permanent and remove any doubt.

GIFT FRUSTRATION Where the new law could be costly for the wealthy and the affluent alike is two new provisions around gifts.

Several states have provisions to prevent people from giving away everything on their deathbed to avoid taxes. New York now has a three-year window. Within that