Tax and Non-Tax Estate Planning Techniques for the New York Resident

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Introduction

Most clients begin the estate planning process with a primary goal of saving estate taxes and having their children inherit as much as possible without federal and state governments taking their pieces. While tax planning has become more important and technically challenging, a number of non-tax issues arise when preparing the estate plan that must be incorporated into the documents.

Asset protection for the client and his or her children has become a significant concern in this litigious society. Many of the techniques used in estate planning can be used effectively to protect the assets and avoid creditors. Also, ensuring that the family business passes down the family in an orderly and fair manner must be incorporated into the estate plan.

Most of our clients are worried about the unknown that may or may not occur after their deaths, and they would like to plan for those contingencies. While planning to minimize estate taxes is significant, we spend an equal amount of time discussing non-tax planning.

Recent Increases in the New York/Tri-State Area Estate Tax Exemption Amounts

As of April 1, 2014, the New York estate tax exemption increased from $1,000,000 to $2,062,500, and as of April 1, 2016, it is $4,187,500. The exemption is scheduled to increase to $5,250,000 on April 1, 2017, and on January 1, 2019, it will match the federal exemption.

When Governor Andrew Cuomo first proposed the law that increased New York's estate tax exemption, his goal was to make New York competitive with Florida in the estate tax area and prevent more taxpayers from leaving New York. For many years, New York has seen a significant decrease in the number of taxpayers, with a large percentage of them moving to Florida, where there is no income or estate tax. This change was intended to keep a large swath of New York residents from moving out of state. The analysis was simply that New York would lose money on the estate tax, but make it up with continued receipt of income taxes.

The change, however, is not favorable for everyone. For individuals with estates that exceed the exemption who decide to remain in New York, the price they will pay is significant. Under the old law, the New York estate tax exemption was $1,000,000 and had graduated rates between 5 percent and 16 percent for the assets *exceeding* $1,000,000. The current law creates a "cliff" tax, in that once the value of the estate exceeds 105 percent of the exemption, the estate will receive *no* exemption. Instead, the estate will be taxed back to the first dollar. The change in the law magnifies the importance of reviewing a client's estate plan to minimize this tax.

Unlike the federal estate tax exemption, the New York estate tax exemption, like every state that has an estate tax, is not portable. A portable exemption means that, without any planning, when the first spouse dies, any unused exemption will port, or pass, to the surviving spouse, thus doubling the available exemption. In essence, the New York estate tax exemption is a "use it or lose it" exemption. Therefore, we attorneys need to create an estate plan that considers each spouse's exemption to double its usage. For example, assume that husband has $4,000,000 of assets in his sole name and wife has $4,000,000 of assets in her sole name. If husband had a "simple will" that left his $4,000,000 outright to wife, there would be no estate tax upon his death (because of the unlimited marital deduction), but wife would be worth $8,000,000 and, upon her death, assuming nothing is left to charity, the children would pay $773,200 of estate tax. Instead, if husband's will had a credit shelter trust that held the maximum amount that can be sheltered from New York estate tax in trust for wife, then when wife subsequently dies, she would be worth only $4,000,000, and the entire $8,000,000 would pass estate tax-free to the children.

The increased exemption will not only have a significant impact on reducing the exodus of taxpayers from New York to states such as Florida, but also has made New York more attractive than its neighboring states from an estate tax exemption. New Jersey has the lowest exemption in the country at $675,000, and Connecticut's is $2,000,000 (down from $3,500,000 in 2010). The New Jersey legislature has reacted to New York by proposing, as of this writing, to increase the exemption as of January 1, 2017, to $1,000,000; $2,500,000 on January 1, 2018; $3,500,000 on January 1, 2019; and $5,000,000 on January 1, 2020; and on January 1, 2021, the exemption is eliminated.

Connecticut is the most problematic state with respect to this issue. Not only is its estate tax exemption quite low ($2,000,000), but also, within a few years, it will be the lowest exemption in the United States. In addition, under Connecticut law, every estate must pay a separate probate fee, whether or not the decedent's will is probated through the local probate courts. This fee was largely dictated by Governor Dannel Malloy because the state was short of funds to maintain its courts; simply put, the probate fee serves as a mechanism to help the Connecticut courts become self-funding. Essentially, a 0.5 percent fee is imposed on every estate in Connecticut that exceeds $2,000,000 for deaths after January 1, 2015—again, whether or not the will in connection with the estate is probated.

In 2015, I handled three different estates in Connecticut, none of which had to be probated because the decedents each had funded revocable trusts or other testamentary substitutes (such as joint property) in place. However, the courts still assessed this fee, which is being used to pay salaries and administration expenses for the local probate courts.

Utilizing Generation-Skipping Trusts for Asset Protection

Aside from the tax issues that affect New York estate planning clients, significant non-tax matters are also of paramount concern. In fact, the number one issue I encounter daily as an estate planning attorney is planning for my client's children and grandchildren to keep the client's assets passing within the family bloodline. About 98 percent of the wills and trusts that we draft are geared around this issue. Again, while estate taxes are a significant area of concern for our clients, an equal amount of discussion centers on how to make sure that the client's children have access to the client's assets—but not unilaterally—and to ensure that the grandchildren receive assets when the client's children die.

Two primary concerns of our estate planning clients involve the divorce and death of our clients' children. In New York and in many other states, inherited and gifted monies are exempt from a divorce settlement and remain separate property *as long as* those assets are not commingled with the marital assets. However, this rarely occurs, and when a child receives monetary gifts or inherits assets, the assets are typically deposited into the couple's joint account, along with the other marital funds. The result is that the account is "tainted" and is no longer protected from a divorce settlement.

Equally concerning to clients is how their assets will be disposed of after the deaths of their children. Without any planning, the assumption will be that if parent leaves assets outright to child, child will leave those inherited assets, along with the marital assets, to in-law. Now what happens? If in-law remarries, the result is that in-law's new spouse will likely end up owning some (if not all) of parent's assets. There is no guarantee that the grandchildren will inherit from parent.

To prevent both of these calamities, we recommend that our clients, within their wills or revocable trusts, hold the children's inheritances in generation-skipping trusts for the children. The original purpose of a generation-skipping trust was to avoid estate tax upon the death of the child. That is still a viable concern, but not paramount to our clients. The child has access to the money upon the client's death; when the child dies, whatever is left passes to the client's grandchildren. Typically, the child has the right to receive the income.

Additionally, the child has the unilateral right to withdraw the greater of $5,000 or 5 percent of the trust's principal every year and, if that is insufficient for his or her needs, the child can receive however much more principal is needed to maintain his or her standard of living, with the consent of a co-trustee. The client looks at this type of plan as if he or she is "dictating from the grave" as to where the assets will pass. The client typically wants to ensure that the children get to use the money, but whatever is left over must pass to grandchildren, not in-laws, friends, new spouses, et al.

A generation-skipping trust can be viewed as providing overall asset protection. Not only are in-laws creditors, but the child may have general negligence creditors (because of a car accident) or malpractice creditors (if the child is a professional, such as a doctor or lawyer). Likewise, a generation-skipping trust provides protection from general business creditors. For example, if a child of a client is a real estate developer and is sued, his or her inheritance will be protected from creditors if it is in a generation-skipping trust.

Succession Planning for a Family Business

Another non-tax-related concern for New York estate planning attorneys is succession planning for clients who own a family business. This typically entails ensuring that when the parents/business owners die, those children who are actively involved and employed in the family business will inherit the business, and the inactive children will receive other assets.

Basic succession planning is just that: basic. It involves working with the assets on hand without any real creativity and can result in inequities. Succession planning not only encompasses general estate planning techniques, but also requires knowledge of corporate and partnership law, as well as the corresponding tax issues to result in a comprehensive solution that is fair to all parties.

Let us look at a scenario with father, mother, active child, and inactive child. Assume the parents leave the business to active child and the house and bank accounts to inactive child. The problem with that planning strategy is fairness because the business and the other assets are typically not worth equal amounts. The family business is usually worth a larger percentage of the client's estate, and using other assets to equalize the inheritance amount for the inactive child is not a fully fair solution.

To create an equitable result, a technique we typically use is to incorporate the terms of a shareholders' agreement into the wills or revocable trusts. For example, assume parents have three children, one active child and two inactive children, and assume that the value of the business exceeds one-third of the estate. If we were to leave the entire family business to the active child and the rest of the clients' money to the two other children, that would not be a fair result because the active child would end up with more than one-third of the estate. Conversely, the parents should leave as much of the business as it would take so that active child receives one-third of the estate and the balance of the business and other assets would pass to the two inactive children.

This strategy is fair because all three children receive the same amount, but it will also result in some very dissatisfied clients. The active child is upset that the inactive children have shares in the business because the active child plans to be working for the business for a number of years, and if the active child ultimately sells the business for a gain, the siblings will have a free ride on the sales proceeds—in other words, they will receive a large part of the proceeds when the business is sold without having worked for it. On the other hand, it may be that the inactive children do not want to own any shares or interests in the business. To the inactive children, those shares are wallpaper because they have never paid dividends in the history of the company, and they would like to sell their shares as soon as possible.

To satisfy both parties, the wills or revocable trusts would provide for the active child to buy out the inactive children (a "call") and for the inactive children to have a right to sell their shares to the active children (a "put") so that their shares become liquid. The purchase price will be fair market value based on the same formula that is used to determine the estate tax value at the second spouse's death. According to Chapter 14 of the Internal Revenue Code, transactions among family members must be for fair market value, so the technique used to calculate the estate tax value can be the basis for the buyout price (it just needs to be updated to the date of the buyout), since, by definition, that must be fair market value. Therefore, the sale price will be fair, and both sides will receive their rightful inheritance amounts. Ultimately, both parties will be happy because they will receive what they want: the active child will receive the family business, and the inactive children will now have liquid funds they can invest. Likewise, the inactive children will no longer be involved in the family business and will be unable to look at the corporate books while the active child can grow the company and receive the fruits of this labor if the company is later sold.

Creditor Protection Trust Strategies for Professionals

Yet another non-tax issue that frequently arises in the context of New York estate planning, as previously noted, is creditor protection for professionals, such as doctors, dentists, lawyers, accountants, architects, and engineers. Asset protection for professionals dovetails with estate planning in that, while we are creating trusts for tax purposes, many of the same planning techniques can be used for asset protection purposes.

For example, assume that we are engaged in estate planning for a married couple where the wife is a surgeon and has potential malpractice issues and the husband is an employee of a company, serving in a position where he would not be exposed to creditor claims. A simple asset protection planning strategy for such a couple would involve titling the couple's assets in the name of the husband, who is less exposed to creditors. Once this is done, the wife is creditor-proof; her creditors cannot attach her husband's assets—only those assets that are in her name can be reached by creditors. In most cases, the only assets the wife would have in her name would be retirement accounts and life insurance. Qualified retirement accounts, such as defined benefit, profit-sharing, and 401(k)[1] plans, are protected from creditors in every state, and many (but not all) states also have a "shield law" that protects individual retirement accounts (IRAs). Life insurance proceeds are not reachable by creditors in New York; however, for estate tax reasons, life insurance policies are typically owned by an irrevocable trust to avoid federal and New York estate tax on the proceeds and cannot be reached by creditors while in the trust, as well.

If the planning stopped here, there would be a problem if the husband predeceased the wife. If he had a simple will that left everything to his wife, then she would now own everything and be exposed to creditors. Instead, the husband should have a will or revocable trust that provides that all of his assets be held in trust for his wife. The amount equal to the federal estate tax exemption would first be retained in a credit shelter trust, and the balance, if any, would be retained in a qualified terminable interest property (QTIP) trust for the wife. That credit shelter trust can be very restrictive and can distribute income and principal only at the discretion of the trustee. The QTIP trust requires that the wife receive the income annually, but if she needs access to principal, she can access it with the permission of a co-trustee. With this strategy, the client is covered in two situations. First, during both spouses' lifetimes, the wife is creditor-proof because she does not have assets that are reachable by creditors. Second, if the husband predeceases her, he will leave everything in trust for his wife so that his assets cannot be reached by creditors.

The only catch with this type of planning is that if the wife predeceases her husband, she does not have any assets to fill her credit shelter trust and take advantage of her New York estate tax exemption, since, as previously

[1] 26 U.S.C.A. § 401(k).

mentioned, that exemption is not portable. To handle that situation, the technique used in Private Letter Ruling (PLR) 200403094 offers an option. In that PLR, the husband had a funded revocable trust and gave the wife a general power of appointment equal to the federal and state estate tax exemption. This power was exercised at her death to bring assets back into her name, and those assets were then used to fill the credit shelter trust. In New York, if that power of appointment is exercised at the wife's death, her assets are not reachable by a creditor.

The only significant issue with this type of planning is the need to advise your client about the fraudulent conveyance rules, which prohibit transfers to defeat a creditor. In other words, if a person is sued and decides the next day to transfer all of her assets to her spouse, the creditor will argue that the transfer was made to avoid the creditor, and the result will be to bring the assets back into the debtor's estate. Therefore, our goal is to make sure that we do this planning well in advance of any creditor actions so that the client's assets are protected and there is no concern about conflicting with the fraudulent conveyance rules.

Conclusion: Forecast on New York Trusts and Estates Law

Regardless of whether the estate tax is ultimately repealed by a future Congress or president, I believe that asset protection-focused estate planning should never change. Our typical trust strategies are still commonly used, and asset protection is as much of a concern now as it ever has been—and it will probably be as much, if not more, of a concern in the future.

Clients are always focused on estate taxes, but whether they live in a state where there is a high estate tax exemption or a state with a fairly low exemption, such as Connecticut, they are resigned to the fact that they will always have to pay some tax or fee in relation to their estates. Therefore, the bulk of the estate planning process ends up revolving around non-tax issues.

There was some concern that if the estate tax was repealed in 2010, there would be no estate planning left to do. However, we have since realized that tax planning represents only 50 percent of what our clients are concerned about; the other 50 percent involves maintaining the family structure and ensuring that only the clients' blood relatives will inherit their estate. Again, there is still plenty of discussion about using life insurance and gifting to minimize taxes. Because of the high federal exemption, most of our tax-related estate planning revolves around estate state taxes, which are still a large concern. I think, however, that every practitioner in this area must still have an extremely strong tax law background.

Key Takeaways

- Keep in mind that the goal in setting up a generation-skipping trust is to ensure that when the client's child dies, whatever is left over from the client's estate has to pass to the client's grandchildren and not to a son-in-law or daughter-in-law. A generation-skipping trust can also be used for asset protection purposes if the client's children or grandchildren receive claims from creditors.
- Include provisions within wills and trusts that provide for the active children in a family business to buy out the inactive children, and for the inactive children to have a right to sell their shares to the active children so that their shares become liquid.
- Make sure that you do any estate planning for professionals well in advance of any creditor actions so that the client's assets are protected and there is no concern that they are conflicting with the fraudulent conveyance rules.
- Ensure that you have an extremely strong tax law background. Keep in mind that most clients are referred by their accountants or financial advisors, who are concerned about estate taxes that will be imposed after the client's death. However, you must also help your clients understand how useful trusts are; explain that basic credit shelter and QTIP trusts may still be necessary, even if there were no estate taxes.

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Mr. Markhoff is a past president of the Estate Planning Council of Westchester County Inc. (2007–2008), where he also served on the board of directors 1998–2001; a past president of the Hudson Valley Estate Planning Council (2012–2013), where he also serves on the board of directors; a past chairman of the Trusts and Estates Section of the Westchester County Bar Association (1998–2000); a past director of the Westchester Chapter of the Society of Financial Service Professionals (2001–2005); and a past president of the Northern Westchester Bar Association (2001–2002) and the White Plains Bar Association (2004–2005). He was the Ninth District Delegate to the New York State Bar Association Trusts and Estates Section (2003–2005), as well as a member of its Executive Committee (2000–2005). He also served as the Ninth District Delegate to the House of Delegates of the New York State Bar Association (2005–2008).

Mr. Markhoff has been a member of the Board of Advisors of the Westchester Community Foundation since 2012 and the Board of Directors of Hudson Valley Investment Advisors since 2014. He was a member of the Board of Directors of Fox Lane Youth Lacrosse Inc., from 2013 to 2015, and was a member of the Board of Trustees of the Bedford Free Library from 2005 to 2014.