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New York's estate tax and non-residents

It is not news that in late March of last year, New York changed its estate tax law. What may be news, however, is how favorable this revised law is for non-resident decedents with real or tangible personal property located in New York.

Background. Prior to the changes, New York only had a $1 million estate tax exclusion, which rapidly disappeared if a decedent's taxable estate exceeded it. With these changes, New York still has a disappearing exclusion (it's gone if the decedent's taxable estate exceeds it by 5%), but at least it's growing: it is currently $3.125 million, and by 2019, will match the inflation-indexed federal basic exclusion amount (currently $5.43 million). More importantly, for purposes of this discussion, New York now has a "stand-alone" estate tax that is no longer based on the defunct state death tax credit (a revenue-sharing arrangement between the states and Uncle Sam that meant that Uncle Sam got fewer estate tax dollars).

New York's old estate tax approach could have unhappy results, say, for married couples who lived outside of New York but still owned New York real or tangible personal property – even if that property was worth less than New York's $1 million exclusion and was passing to the surviving spouse (a disposition that typically qualifies for the marital deduction – and therefore defers estate tax – as long as the surviving spouse is a U.S. citizen). To illustrate:

> **"Old" New York law.** Mom and Dad are both U.S. citizens and live in Florida, which has NO state estate tax. Mom's estate totals $8 million, including her ½ interest in their jointly owned $800,000 Long Island beach condominium. Mom dies in January 2014, when the federal exclusion is $5.34 million (she never made any lifetime gifts that eroded that exclusion). Her will creates a $5.34 million credit shelter trust for Dad and their children that will pass estate-tax free in both her *and* Dad's estates. The condo passes automatically to Dad by right of survivorship, and qualifies for the marital deduction. To Dad's surprise, Mom's $400,000 interest in the condo is nevertheless subject to New York estate tax, even though it is passing to him, and is well under New York's $1 million estate tax exclusion. The reason?

New York treats Mom as if she were a New York resident, and her taxable estate – the $5.34 million credit shelter trust for Dad – exceeds New York's $1 million exclusion, thereby triggering hypothetical New York estate tax of $431,600. Since Mom's interest in the condo represents 5% of her estate, her New York estate tax is $21,580 (5% of $431,600).

The "new" New York estate tax produces a dramatically different result in this example: New York now only taxes non-resident decedents on their New York-situs real and tangible personal property; it also gives residents and non-residents alike the same New York estate tax exclusion, and does not reduce a non-resident decedent's exclusion to reflect the ratio of New York property to the decedent's overall estate. To illustrate:

"New" New York law. Same facts as above, except that Mom dies in April 2014. Her estate owes no New York estate tax, as the disposition to Dad qualifies for the marital deduction, which defers estate tax until Dad's death. Even if Mom were widowed and left the $800,000 condo to her children, her estate would still not be subject to New York estate tax because her New York taxable estate (the condo) is under the $2,062,500 New York exclusion in effect at her death. If widowed Mom's condo were worth $2,062,500 and she left it to her children, her estate would owe no New York estate tax; if her condo were worth $2,165,625 (5% more than the New York exclusion at her death), her estate would owe $112,050 in New York estate tax – the same amount that a resident decedent would owe if her taxable estate were over the exclusion amount by 5%.

Comments. This change for non-residents is a big deal – and means that non-resident married couples with New York real or tangible personal property will no longer have the unhappy surprise illustrated above at the first spouse's death. Indeed, regardless of the size of the non-resident's New York estate, if it passes to the surviving spouse in a disposition that qualifies for the marital deduction, no New York estate tax will be payable until the surviving spouse's death (assuming the spouse still owns that New York property at death).[1] But what about once that spouse is widowed – or suppose the New York non-resident is single? Is there a way to reduce the potential New York estate tax on that New York property, assuming its value will likely exceed the New York exclusion in effect at that non-resident's death?

Before addressing that question, let us review a few things:

- The New York estate tax applies to a non-resident's real or tangible personal property that is located in New York; it does not apply to a non-resident's "intangible property."
- "Intangible property" refers to items such as stocks, bonds and interests in entities such as limited liability companies and partnerships; it is deemed to "reside" with its owner.
- The New York State Constitution bars New York from imposing estate tax on a non-resident's intangible property (see Article XVI, § 3).
- A "single member limited liability company" is a limited liability company (LLC) with one member; unless that single member LLC has elected to be treated as a corporation, it is disregarded for income tax purposes, and is effectively treated as "one" with its owner/member.
- A Subchapter S corporation is a "pass-through" entity that passes through its income to shareholders, and is therefore not subject to corporate-level income tax.

[1] Note that, in general, if the non-resident gives away New York real or tangible personal property (or intangible property connected with a New York trade or business) within three years of death, New York will pull that property back into the non-resident decedent's New York estate.

- A condominium is considered real property (unlike a cooperative apartment).
- An Advisory Opinion from the New York State Department of Taxation and Finance is issued at the request of the taxpayer who requested advice about the New York state tax consequences of a proposed transaction or set of facts. Like a private letter ruling from the IRS, the opinion's holding only applies to the taxpayer who requested it. Although it is based on an analysis of the law, regulations and current Department policies, the opinion will not necessarily be upheld if a taxpayer litigates the issue.

Enter several Advisory Opinions dealing with non-residents, intangible property and New York estate tax:

- **TSB-A-15(1)M** (May 29, 2015). Taxpayer (T), a New York resident, inquires about the following: T is thinking about forming a single member LLC under Delaware law for the "sole purpose" of contributing his New York condominium to the LLC and then moving to another state. T would be the sole owner of the LLC for the rest of his life and would reside outside of New York State until his death. The LLC would be a "disregarded entity" for income tax purposes. Would it be considered "intangible property" for New York estate tax purposes?

  What the opinion said. The analysis noted the following: a) where a corporation, partnership or trust owns New York real property (including condominiums), cases have held that interests in such an entity constitute intangible property; b) the New York State Constitution prohibits New York estate tax on a nonresident's intangible property, "even if such property is located in New York State"; and c) a single member LLC that is a disregarded entity for income tax purposes is not deemed to be separate from its owner. Based on this analysis, T's interest in the single member LLC "would not be treated for estate tax purposes as an intangible asset," and the condominium owned by the LLC would be treated as real property held by T for New York estate tax purposes.

- **TSB-A-08(1)M** (October 24, 2008). Here, T had a similar query. She was a Florida resident who wanted to buy a New York condominium through an entity she would create. Which one would be treated as intangible property for purposes of the New York estate tax: a Florida S Corporation, or a single member LLC?

  What the opinion said. The upshot of the opinion was that if there were a business purpose for the S Corporation and it was "entitled to recognition for tax purposes," then, yes, T's holding in the S Corporation could be considered intangible property that would not be subject to New York estate tax; if the S Corporation were not entitled to recognition under that standard, then the condo would be included in T's New York gross estate. The same analysis would apply to a single member LLC.

What does this mean? In a nutshell, New York is well aware of why a non-resident might want to "convert" New York real property into intangible property that would not be subject to New York estate tax at that non-resident's death. What is clear from these two opinions is that a single member LLC will not suffice: does that mean that a multi-member LLC will work? Suppose, for example, that non-resident Mom and Dad are the two members of the LLC that owns a New York condo; will this structure insulate the condo from New York estate tax when the first of them dies? Arguably yes, although the New York tax could be moot at that point if the deceased spouse's LLC interest simply passes to the surviving spouse and qualifies for the marital deduction. The dangling issue is what happens when the surviving spouse is now the sole member of the LLC, which presumably becomes a disregarded entity.

A final note. It is worth contrasting the holdings of these two opinions with the actual language of New York's estate tax law and its constitution. As noted above, the tax law (§ 960 of Article 26) says that estate tax applies to a non-resident decedent's transfer of "real and tangible personal property having an actual situs in New York state." § 3 of Article XVI of New York's constitution, dealing with the taxation of intangible property, states in part: “Moneys, credits, securities and other intangible personal property within the state not employed in carrying on any business therein by the owner *shall be deemed to be located at the domicile of the owner for purposes of taxation* [italics added].”

In other words, the opinions reflect Tax Department policy that doesn’t necessarily square with the literal language of the underlying law. Stated differently, the opinions are designed to have a chilling effect, and seem to represent New York’s litigating position – namely, that a single member LLC/disregarded entity holding New York real estate will not insulate that real estate from New York estate tax at the non-resident owner’s death. This is a point that a wealthy non-resident decedent’s estate might be willing to contest. Nevertheless, that same non-resident might prefer to avoid the issue entirely, and perhaps buy a cooperative apartment instead (a co-op is intangible property), or seek a more complex ownership structure for the condo.

August 7520 rate

The IRS has issued the August 2015 applicable federal rates: the August 7520 rate is 2.2%, the same as July’s 7520 rate. The August mid-term rates are: 1.82% (annual), 1.81% (semiannual and quarterly) and 1.80% (monthly). The July mid-term rates were: 1.77% (annual), 1.76% (semiannual and quarterly) and 1.75% (monthly).

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