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## New York Lifts Death Tax Penalty

### **Cover Page Footnote**

B.S., 1984 and J.D., 1987, Fordham University. Has taught on the Adjunct Faculty at both Fordham University School of Business and the Iona College of Business. The author would like to thank Professors Sharpe and Katsoris of Fordham University School of Law for their invaluable suggestions and comments.

# NEW YORK LIFTS DEATH TAX PENALTY

Nancy O'Hagan\*

## Introduction

New Yorkers pay a myriad of local taxes,<sup>1</sup> including sales and use tax, gasoline and motor fuel tax,<sup>2</sup> cigarette and tobacco tax,<sup>3</sup> stock transfer tax,<sup>4</sup> and real estate transfer tax,<sup>5</sup> to name a few. Most of these taxes are principally consumption oriented, or involve some transaction or use. The New York State income,<sup>6</sup> gift, and estate taxes,<sup>7</sup> however, are basically imposed for the privilege of living or dying in New York. It is when these taxes become oppressive that residents decide to "bail out" to more sympathetic jurisdictions.

When citizens or residents of the United States die, their property is subject to the Federal estate tax no matter where the property is located.<sup>8</sup> If that property is located outside of the country, the foreign situs also generally has the right to tax that property at death.<sup>9</sup> To avoid the double taxation of such property, the United States has entered into numerous treaties.<sup>10</sup> Alternatively, the Internal Revenue Code ("Code") provides for a credit against the U.S. estate tax for foreign death taxes.<sup>11</sup>

Similarly, when a United States citizen or resident dies as a domiciliary of a state, that state will generally impose a death tax on her intangible property wherever situated, and on her realty and tangible personalty located within the state.<sup>12</sup> Tangible personalty or realty situated outside the state of domicile is generally taxed by the

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1. See NY TAX LAW §§ 1101-1148 (McKinney 1987 & Supp. 1987-1997).

2. See NY TAX LAW §§ 282 to 289-f (McKinney 1986 & Supp. 1987-1997).

3. See NY TAX LAW §§ 470-482 (McKinney 1987 & Supp. 1987-1997).

4. See NY TAX LAW §§ 270 to 281-a (McKinney 1986 & Supp. 1987-1997).

5. See NY TAX LAW §§ 1400-1410 (McKinney 1987 & Supp. 1987-1997).

6. See NY TAX LAW §§ 601-699 (McKinney 1987 & Supp. 1987-1997).

7. See NY TAX LAW §§ 951-961 (McKinney 1987 & Supp. 1987-1997).

8. See I.R.C. § 2031(a) (1995).

9. See HOMER HARRIS, FAMILY ESTATE PLANNING GUIDE 150-51 (Frederick K. Hoopes ed., 3d ed. 1982).

10. See *id.* at 149-50.

11. See I.R.C. § 2014(a) (1995).

12. See HARRIS, *supra* note 9, at 147-49.

situs state.<sup>13</sup> Thus, the same property taxed by the states is also taxed in the Federal estate tax proceeding. In order to prevent such double taxation, the Code permits a credit against the Federal estate tax for death taxes so paid to the states for property included in both proceedings.<sup>14</sup> In most instances, this credit gives full relief from such double taxation. In some states, however, such as New York, the credit relief is not adequate.<sup>15</sup> In the case of the New York State Gift Tax, the injustice was even more pronounced because there simply was no federal credit available for the tax.<sup>16</sup>

Recently, New York State sought to relieve the burden of its excessive gift and estate taxes upon its residents.<sup>17</sup> New York State replaced its estate tax and repealed its gift tax. This Article will trace the history of the New York State gift and estate taxes upon its residents, explain the burden they imposed upon its residents in relation to other states, and examine the recent legislation in New York State which will gradually eliminate such inequities.

### I. Present New York Estate and Gift Taxes

For decades, New Yorkers have been at a severe estate planning disadvantage compared with those living in most other states. The federal estate and gift tax was imposed only upon transfers, either during life or at death, in excess of \$600,000 (the amount sheltered by the federal "unified credit").<sup>18</sup> Moreover, this unified credit will gradually creep up to a one million dollar exemption by the year 2006.<sup>19</sup> On the other hand, New York imposed its estate and gift tax on transfers in excess of only \$115,000.<sup>20</sup> Admittedly, the Federal estate tax allows a credit of up to 16% for state death taxes;<sup>21</sup> however, since the top New York estate tax rate is 21%,<sup>22</sup> there is a shortfall of 5% on large estates. Moreover, the New York gift tax

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13. *See id.*

14. *See* I.R.C. § 2011(a) (1995).

15. *See infra* notes 35-40 and accompanying text.

16. *See infra* notes 22-3 and accompanying text.

17. *See* Tom Precious, *New State Law to End Taxes on All But Richest Estates*, BUFFALO NEWS, Oct. 5, 1997, at B12.

18. *See* I.R.C. § 2010 (1995) (allowing a credit of \$192,800 which is precisely the tax on the first \$600,000 of taxable estate).

19. *See* Precious, *supra* note 17, at B12. The applicable exclusion amount will be increased in stages, starting with \$625,000 in 1998 and gradually going up to \$1,000,000 in the year 2006 and thereafter. *See* I.R.C. § 2010 (c) (1997).

20. *See* N.Y. TAX LAW § 952(a) (McKinney 1987 & Supp. 1987-1997).

21. *See* I.R.C. § 2011 (1995).

22. *See* N.Y. TAX LAW § 952(a) (McKinney 1987 & Supp. 1987-1997).

is particularly oppressive because there is no federal credit at all for state gift taxes.

New York State also imposes an income tax on its residents.<sup>23</sup> For income tax purposes, however, a New York resident is a person who: (1) is domiciled in New York,<sup>24</sup> or (2) *is domiciled elsewhere*, but maintains a permanent place of abode in New York and spends, in the aggregate, more than 183 days of the taxable year in the state.<sup>25</sup>

Unlike the definition of residence for income tax purposes, however, the term resident for New York estate purposes is synonymous with the decedent's domicile.<sup>26</sup> The elements for establishing domicile are the decedent's manner of living and her actual intent or conduct.<sup>27</sup> Moreover, no single factor is controlling, and the decedent's intention must be ascertained from the overall set of facts.<sup>28</sup> In this regard, although maintaining a permanent place of abode or spending more than 183 days of the taxable year within the state do not in and of themselves constitute domicile, such contacts would obviously be most important factors in the determination of domicile.<sup>29</sup>

Some states, such as Florida, limit their death tax to an amount not in excess of the federal state death tax credit ("state tax credit").<sup>30</sup> Thus, Florida's death tax is characterized as a "sop" or "sponge" tax because it fills the gap of the state tax credit<sup>31</sup>. If no state tax credit exists, no sop or sponge tax exists.<sup>32</sup> Accordingly, the sop or sponge tax is whatever the state tax credit allows, and since the credit reduces the federal estate tax due, there is no additional cost to the taxpayer's estate.<sup>33</sup> For example, in 1997, when the unified credit would shelter a taxable estate of \$600,000 from the federal estate tax, there would be no state tax credit and, therefore, no Florida death tax.<sup>34</sup>

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23. See N.Y. TAX LAW § 601 (McKinney 1987 & Supp. 1987-1997).

24. See N.Y. TAX LAW § 605(b)(A) (McKinney 1987 & Supp. 1987-1997).

25. N.Y. TAX LAW § 605(b)(B) (McKinney 1987 & Supp. 1987-1997).

26. See N.Y. TAX LAW § 952 (McKinney 1987 & Supp. 1987-1997); see also HOMER HARRIS, ESTATES PRACTICE GUIDE § 617 (3d ed. 1968).

27. See 3 N.Y. Tax Reporter (CCH) § 88-105 (May 1984).

28. See *id.*

29. See *id.*

30. See Constantine N. Katsoris, *The New York State Tax Windfall*, 15 FORD. URB. L.J. 199, 204 (1986-87).

31. See *id.*

32. See *id.*

33. See *id.*

34. See *id.*

The New York estate tax, however, was not computed with reference to the federal state tax credit.<sup>35</sup> Thus, one can incur a New York estate tax, even though there may be no federal estate tax due. This result comes from the fact that, although many of the New York estate tax provisions mirror the federal estate tax, the New York estate credit is not nearly as generous as the federal unified credit.<sup>36</sup> Thus, a Florida estate of \$600,000 would be subject to neither federal estate tax (because of the unified credit)<sup>37</sup> nor Florida death tax (since it cannot exceed the state tax credit, which in this case is zero).<sup>38</sup> Yet, a New York estate of \$600,000 would be subject to a New York estate tax of \$25,500.<sup>39</sup>

Furthermore, in a New York estate—even when there is a federal estate tax—the New York estate tax rates can exceed the federal state tax credit by as much as 5 percent.<sup>40</sup> No such excess occurs in a sop or sponge tax jurisdiction, because in those jurisdictions, the state death tax will never exceed the state tax credit.<sup>41</sup>

## II. The New York City Experiment

In 1975 New York City faced severe economic conditions.<sup>42</sup> It could no longer roll-over its existing debt at any price, nor could it finance its ever-widening deficits by issuing additional debt.<sup>43</sup> Something had to be done, and the relief took the form of a compromise that included severe budget cuts, massive purchases of local debt by the City pension funds, a debt moratorium and the paring of interest rates, the granting of federal short-term seasonal credit of up to \$2.3 billion, which required increased contributions to City pension plans from city workers, and the imposition of additional City taxes on the already overburdened taxpayers of New York City.<sup>44</sup>

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35. See N.Y. TAX LAW § 952(a) (McKinney 1987 & Supp. 1987-1997).

36. See N.Y. TAX LAW § 952(b) (McKinney 1987 & Supp. 1987-1997).

37. See *supra* note 18 and accompanying text.

38. See *supra* note 30 and accompanying text.

39. The New York estate tax on \$600,000 is \$26,000, N.Y. TAX LAW § 952(a) (McKinney 1987 & Supp. 1987-1997), less a \$500 credit, N.Y. TAX LAW § 952(b)(3) (McKinney 1987 & Supp. 1987-1997).

40. See *supra* notes 18-22 and accompanying text.

41. See *supra* notes 30-34 and accompanying text.

42. See *Perils of New York*, NEWSWEEK, Oct. 13, 1975, at 75; see also John D. Feerick, *The United States Without New York City? Its Resources Vital To Nation's Welfare*, 175 N.Y. L.J., Nov. 17, 1975, at 23.

43. See Michael C. Jensen, N.Y. TIMES, Jan. 4, 1976, at 37.

44. See *Are New York's Agonies Really Over?*, U.S. NEWS & WORLD REP., Dec. 8, 1975, at 34.

One such additional tax imposed by New York City was a municipal death tax, which basically added a surtax of 50 percent onto the New York State estate taxes for New York City resident decedents.<sup>45</sup> Unfortunately, federal credits did not soften the impact of this new tax, as was the case with the New York State estate tax.<sup>46</sup> The Internal Revenue Code permitted a credit against the federal estate tax for death taxes paid to the states; however, since New York State estate tax rates already exceeded the credit allowable against the federal estate tax, no available credit remained for the City tax.<sup>47</sup> Nor could claiming the City death tax as a Federal estate tax deduction ameliorate the effect of the tax.<sup>48</sup>

The City death tax was generally imposed upon the property of a resident decedent, wherever located, specifically excluding realty or tangible property situated outside of New York City.<sup>49</sup> A decedent, however, could avoid being classified as a resident for purposes of the New York State and City estate taxes by not being domiciled there.<sup>50</sup> That meant that for a taxpayer to prospectively ensure that her estate avoided the City death tax, she must have kept her contacts within the City to a minimum.<sup>51</sup>

Since the upper brackets of the New York State estate tax reach 21 percent,<sup>52</sup> the 50 percent New York City estate tax surcharge could reach as high as 10.5 percent. Moreover, since the limits of the federal estate tax credit for state death taxes would already have been exhausted,<sup>53</sup> the 10.5 percent loss would be a net loss. Common sense, therefore, would dictate that most individuals would take the appropriate steps to ensure that this unnecessary further depletion of their estate—up to 10.5 percent—would not occur. Simply put, no one was eager to pay up to 10.5 percent of her estate for the privilege of dying in the City of New York.<sup>54</sup> The legislature, to its credit, realized the impracticality of the tax it had

45. See WALL ST. J., Nov. 24, 1975, at 5.

46. See *supra* notes 18-22 and accompanying text.

47. See *id.*

48. See I.R.C. § 2053(c)(1)(B) (1995).

49. See Constantine N. Katsoris, *City's Death Tax and Its Possible Effects*, N.Y. L.J., Jan. 29, 1976, at 1, 4 reprinted in 379 N.Y.S.2d 15 (1976).

50. See *id.*

51. See *supra* notes 23-29 and accompanying text.

52. See *supra* note 22 and accompanying text.

53. See *supra* notes 35-39 and accompanying text.

54. "[M]any lawyers and brokers say the take will be much smaller because rich people will move outside city limits before the tax takes effect." WALL ST. J., Nov. 23, 1975, at 3.

just imposed and repealed it before it ever took effect. Fortunately, no New York City gift tax was ever enacted.

### III. Danger: Two States Tax the Same Property

How then does a New York resident plan her estate? Does she continue to maintain contacts in the "Empire State," but meticulously strive to keep her "residence" outside the state, thus avoiding its death tax? The New York State death tax differentiates between a resident<sup>55</sup> and nonresident decedent.<sup>56</sup> What, therefore, does the term *resident* mean?

For purposes of the New York estate tax, the term *resident* is synonymous with domicile.<sup>57</sup> In determining the decedent's domicile, the manner of living and actual intent and conduct of the decedent are the essential elements considered, rather than the time spent in a particular place.<sup>58</sup> Determining domicile is a question of fact, based upon many elements, including where the decedent voted where she conducted business activities, the center of her social affairs, where she referred to as home, where she lived the greatest portion of time, the location of her principal possessions, and where she paid local taxes indicative of residence.<sup>59</sup> No single factor controls—the intent must be ascertained from the overall picture.<sup>60</sup> "The result may be that a number of states may claim that the decedent was domiciled there, as where the decedent may have homes in different places. Indeed, the fact that one state determines domicile does not bar another from determining that the decedent's domicile is in that state."<sup>61</sup>

Many New Yorkers, therefore, who sought to change their domicile to a sop or sponge death tax state, had to ensure that they left few if any contacts in New York, lest it later be claimed that the individual was still domiciled in New York State at death. This was

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55. In the case of a resident, the New York estate tax is generally imposed on all of her property except realty or personalty situated outside the state. *See supra* notes 12-13 and accompanying text.

56. In the case of a non-resident, the New York estate tax is imposed only on her real and tangible personal property having an actual situs in New York State. *See* N.Y. TAX LAW § 960(a) (McKinney 1987 & Supp. 1987-1997).

57. *See supra* notes 23-29 and accompanying text.

58. *See id.*

59. *See* 2 New York Tax Reports (CCH) §§ 88-105 (May 1984).

60. *See id.*

61. *See* HOMER HARRIS, *supra* note 9, at 149-50. Many states have adopted statutes providing for compromise and arbitration of the claims of different states where domicile is disputed. *See id.*; *see also* Texas v. Florida 306 U.S. 398 (1938); Dorrance v. Martin, 184 A. 743, *cert. denied*, 298 U.S. 678 (1936).

often difficult, particularly if the decedent retained residences, businesses, and other contacts in New York. With the new legislation,<sup>62</sup> New Yorkers will not have to shed their New York assets and contacts in order to change their New York domicile and avoid the risk of double death taxes at the state level.

#### IV. New Relief Phased In

On August 7, 1997, Governor Pataki of New York signed legislation that will repeal (in the case of decedents dying on or after February 1, 2000) the present New York State estate tax, replacing it with a sop or sponge tax.<sup>63</sup> Moreover, the New York State gift tax will be repealed, without replacement, for gifts made on or after January 1, 2000.<sup>64</sup> This legislation will place New York on par with some 35 other states that impose no excess estate tax and 45 other states that impose no gift tax.<sup>65</sup> In the interim, the new legislation also increases New York's unified credit over the next two and one-half years in order to phase in the repeal of the New Yorker's gift tax and the reduction of New Yorker's estate tax to the amount allowed as a credit against the federal estate tax.<sup>66</sup> This new legislation will cost New York an estimated one billion dollars in lost tax revenues between 1997 and 2002.<sup>67</sup> On the other hand, considering that, from 1992 to 1995, 250,000 New Yorkers moved to Florida,<sup>68</sup> eliminating the death tax penalty "may be a source of New York retaining more of its residents."<sup>69</sup>

#### Conclusion

New York State has finally realized that it must compete with other states to retain its maturing citizens. The elimination of the gift tax and the ultimate imposition of a sop or sponge estate tax goes a long way towards dissuading New Yorkers from fleeing to other states. Moreover, allowing people to retire in New York

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62. See *infra* notes 66-72 and accompanying text.

63. See C. Barletta & R. Kennedy, *Legislature Acts on a Number of NYSBA Proposals*, 39 N.Y. ST. BAR NEWS 1, 30 (Sept/Oct 1997); see also Joshua S. Rubenstein & Eileen Caulfield Schwab, *Historic New York State Estate and Gift Tax Reform*, TR. & EST. L. SEC. NEWSL. (New York State Bar Association), Fall 1997, at 4.

64. See *id.*

65. See Precious, *supra* note 17, at B12.

66. See *id.* "The new state law will raise the exemption level to \$200,000 by 1997, \$400,000 in 1998 and then to \$600,000 by 2,000. Eventually, the level will rise to \$1 million." *Id.*

67. See *id.*

68. See *id.*

69. See *id.*

without a death tax penalty relieves them of the urge to change their domicile to another state while retaining property in New York, which would expose them to the risk of double state taxation at death because of allegations that they were domiciled in more than one state.<sup>70</sup> This estate and gift tax relief was long overdue;<sup>71</sup> however, in this case, it is better late than never.

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70. See *supra* notes 54-63 and accompanying text.

71. See Jonathan G. Blattmachr, *The New New York Estate Tax: An Explanation*, N.Y. ST. BAR J., June 1979; at 266; see also *Matter of Burden*, 91 Misc. 2d. 368; 398 N.Y.S.2d 88 (Sur. Ct. N.Y. County 1977). "One major improvement which will ease New York domiciliaries' tax burden and very probably increase state tax revenues besides, would be to adopt the 'sop-up' estate tax principle used by Florida." *Id.* at 374.