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To Pay Or Not To Pay

Making the decision to pay NJ estate tax after the death of the first spouse

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For many years, New Jersey has had both an inheritance tax and an estate tax. Until 2001, when planning for or administering a New Jersey estate, most practitioners had only concerned themselves with the New Jersey inheritance tax because the New Jersey estate tax had no economic impact as it was based solely upon the federal estate tax system.

Historically, the federal government gave a dollar-for-dollar credit for taxes paid to any state which simply equated to a portion of the tax a decedent paid to the federal government being returned to the state in the form of a State Death Tax Credit. The increases in the estate, gift and generation-skipping transfer tax exemptions and the potential repeal of the estate and generation-skipping transfer taxes under the 2001 Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") changed all of that by eliminating the State

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Death Tax Credit. This article will provide an analysis of the New Jersey estate tax, including the planning and administrative issues of whether to pay New Jersey estate tax after the death of the first spouse.

Instead of facing the loss of revenue from the change in the federal law, New Jersey decided to enact its own estate tax law, which essentially freezes the estate tax revenue stream as it existed on December 31, 2001. At that time, a gross estate of less than \$675,000 did not owe any federal estate tax, and thus did not owe any New Jersey estate tax. Under the recent New Jersey law, if more than \$675,000 is passing to someone other than a spouse, a New Jersey estate tax may be assessed even though the estate is exempt from federal estate tax (the federal estate tax exemption is currently \$2,000,000, and is scheduled to increase next year).

As a result, estates which may be exempt from federal estate tax may now be subject to a separate New Jersey estate tax. Sophisticated and simple estate tax planning techniques used prior to the enactment of this new law may cause an unintended New Jersey estate tax upon a person's death. This is true even if there is a surviving spouse.

Estate tax planning should now be a concern for any person, or couples, residing in New Jersey whose assets are in excess of \$675,000. There is no cap on the New Jersey estate tax. As your assets

increase, so does the New Jersey estate tax. Under the federal estate tax laws in existence as of December 31, 2001, the State Death Tax Credit, upon which the New Jersey estate tax is based, ranged up to 16 percent of the entire taxable estate. Accordingly, the New Jersey estate tax may be as much as 16 percent of the taxable estate, regardless of any federal estate tax liabilities. In order to address this concern, your estate plan must be flexible enough to account for shifting tax laws.

Prior to the new law, a common estate planning technique for married couples was to create a trust (known as a Credit Shelter Trust or By-Pass Trust), which was funded at the death of the first spouse with the maximum federal exemption. The balance of the estate over the maximum federal credit would either pass outright to the surviving spouse or in a marital trust ("QTIP" trust). Now that New Jersey has its own estate tax, upon the death of the first spouse this type of planning could result in a New Jersey estate tax, even though no federal estate tax is due.

By way of example, assume that "Spouse A" has one million dollars in assets, and "Spouse B" has \$350,000. Under the By-Pass Trust technique described above, upon Spouse A's death in 2008, an amount equal to the exemption from federal estate taxes (\$2,000,000) would be used to fund the By-Pass Trust. While there is no federal estate tax upon the Spouse A's death, there is now a New Jersey estate tax of \$33,200 assessed at Spouse A's death.

Under the above scenario, the New Jersey estate tax could have been avoided if the By-Pass Trust was funded with only \$675,000, the maximum exemption from estate taxes in New Jersey. In order to do so, your will must be designed to allow the surviving spouse to determine how and to what extent to fund the By-Pass Trust. One way to accomplish this is to design your estate plan with disclaimer By-Pass Trusts.

Under this plan, all assets pass to the surviving spouse outright. The surviving spouse would then elect to disclaim assets constituting a part or all of that bequest. The amount disclaimed will fund the By-Pass Trust under the first spouse's will for the benefit of the surviving spouse. Section 2518 of the Internal Revenue Code allows for an individual to "disclaim in whole or in part, any interest he or she may have over any property as an inter vivos or testamentary gift.

For purposes of §2518, the term qualified disclaimer means "an irrevocable and unqualified refusal by a person to accept an interest in a property but only if: (1) the refusal is in writing; (2) delivered to the transferor or their legal representative (a) not later than 9 months than the date the transfer is made or (b) the day on which such person attains the age of 21; (3) such person has not accepted the interest or any of its benefits; and (4) the interest passes without the direction of the individual making the disclaimer." New Jersey law provides similar requirements for disclaimers. Specifically, N.J.S.A. 3B:9-1, et seq., provides in relevant part, that any individual

who is an heir, devisee or beneficiary under a will or testamentary trust may disclaim, in whole or in part any property or interest therein, including a future interest, by delivering or filing a disclaimer. N.J.S.A. 3B:9-8 provides that the disclaimed property passes as if the disclaimant predeceased the decedent. Therefore, if a surviving spouse elects to disclaim assets from the first spouse's estate, the will would be designed so that the disclaimed assets pass to the By-Pass Trust for the benefit of the surviving spouse during their lifetime.

However, funding the By-Pass Trust with only \$675,000 instead of the full federal exemption then available will not always reduce the overall estate tax due when passing funds to the next generation. For larger estates, the total estate tax due might be less if some or all of the New Jersey estate tax were paid when the first spouse died. The question then becomes whether to "overfund" the By-Pass Trust up to the current federal unified credit exemption and pay a New Jersey estate tax at the death of the first spouse.

For example, assume the year is 2008 and Spouse A and Spouse B each have two million dollars of assets, for a total of four million dollars. If Spouse A dies in 2008 and funds the By-Pass Trust with only \$675,000, then no federal or New Jersey estate tax will be due. However, if Spouse B also dies in 2008, their estate is \$3,325,000, and taxable under both the federal and New Jersey estate tax. The total tax due at B's death will be \$808,650.00 (a federal estate tax of \$596,250.00 and a New Jersey estate tax of \$212,400.00).

In comparison, if Spouse A had funded the By-Pass Trust with two million dollars, no federal estate tax would have been due (because the amount passing to the By-Pass Trust is equal to Spouse A's exemption from federal estate taxes), but a New Jersey estate tax of \$99,600 would have been due. Upon Spouse B's death, there will be no federal estate taxes, but a New Jersey estate tax of \$99,600 will be assessed. The total tax paid by the couple under this scenario is \$199,200.00, a savings of \$609,450.00 from the first scenario.

Nuances of the New Jersey estate tax has shifted the focus of estate planning to post-mortem planning. The benefit of this approach is that it allows the surviving spouse to assess after the death of the first spouse the estate tax benefits of paying a death at the first spouse's death or deferral of the estate tax liability until the death of the second spouse.

For an average individual living in the state of New Jersey, the New Jersey Estate tax will have an effect. However, one of the platforms of the 2008 presidential election will likely focus on taxes, in particular the estate tax and its scheduled repeal in 2010. One thing that is fairly certain is that, despite the outcome of the presidential election, it is not likely to impact the New Jersey estate tax and the current exemption of \$675,000. Due to property tax reform and budget deficit, it would appear that the New Jersey estate tax is here to stay.

The only certainty in the tax code is change; your estate plan must be flexible enough to deal with anticipated changes. ■