

Estate Planning & Elder Law

Disparity Between Federal And New Jersey Estate Tax Exemptions Heightens

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The federal estate tax exemption increased from \$2,000,000 to \$3,500,000 as of January 1, a 75 percent increase. While it is anticipated that there will be changes to the federal estate tax prior to its scheduled repeal in 2010, it is quite possible that the federal exemption amount will remain at \$3,500,000. The New Jersey estate tax exemption, however, is currently set at \$675,000 and is not expected to increase. Although many clients have estates that may not reach the federal exemption, they still must deal with the New Jersey estate tax and the various issues that are involved. This article will discuss some of the critical planning implications arising out of the significant disparity that now exists between the federal and New Jersey estate tax exemptions.

We have seen a dramatic increase in the federal estate tax exemption amount during this decade. Pursuant to the 2001 federal tax law changes, the state death tax credit was “phased out,” thereby effec-

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tively eliminating the New Jersey estate tax then in effect. As a result, New Jersey enacted new estate tax provisions in 2002 which were made to apply retroactively to decedents dying after December 31, 2001.

If an individual died in 2002 and left the entire federal exemption amount of \$1,000,000 to a trust for the surviving spouse and his or her issue utilizing the deceased spouse’s estate tax exemption, no federal estate tax liability was incurred. However, since the taxable estate for New Jersey estate tax purposes exceeded \$675,000, a New Jersey estate tax of \$33,200 would have been due even though there was no federal estate tax liability. Although this number was relatively small, for estates seeking to utilize the full federal exemption on the first death of two spouses, the potential New Jersey estate tax imposed on the first death has increased significantly as the federal estate tax exemption has increased.

When the federal estate tax exemption increased to \$2,000,000, full utilization of the exemption generated a New Jersey estate tax of \$99,600. In the present year, with the federal exemption at \$3,500,000, the New Jersey estate tax would be \$229,200 if the exemption was fully utilized. This makes it even more important for practitioners to effectuate

estate plans for their clients which take into account both federal and New Jersey estate tax implications.

As a result of the increase in the federal estate tax exemption amount, it is important for New Jersey married couples to review their current estate planning documents. Prior to decoupling, it was common practice for wills to provide for a fully funded federal exemption trust upon the first death. As of January 1, such a trust would be funded with \$3,500,000 resulting in a New Jersey estate tax of \$229,200. Since this may be an unintended and unnecessary result for many clients, there is a good possibility that such a will may no longer make sense and needs to be updated. Alternatively, a will that limits the funding of the exemption trust to the New Jersey exemption amount of \$675,000, with no additional funding possibility, may also not make sense for many clients. This approach would preclude clients from taking advantage of a greater portion of the federal exemption amount, if so desired.

Instead of either of these approaches, both of which lock in a particular result, wills for New Jersey married couples should be structured to allow sufficient flexibility so that decisions as to the funding of the exemption trust can be made following the first death rather than at the

time the will is executed.

With the federal estate tax exemption amount currently at \$3,500,000, it is imperative that estate planning documents provide the necessary flexibility so that the correct decisions can be made on a post-mortem basis. The critical decision is whether and to what extent it makes sense to utilize more than \$675,000 of the decedent's federal exemption thereby generating a New Jersey estate tax on the first death. In some circumstances, it may make sense to pay the New Jersey tax on the first death in order for additional assets to be sheltered from federal and New Jersey estate taxes at the surviving spouse's death.

In general, the desired flexibility can be best achieved by providing in clients' wills for a "qualified disclaimer" to be exercised by the surviving spouse. By using the disclaimer technique, the surviving spouse would have the opportunity to disclaim that amount which he or she deems appropriate to eliminate or at least minimize the estate tax liability at the survivor's death. This allows the surviving spouse to be in control of the process including the decision as to whether New Jersey estate taxes should be paid.

In many instances, it may be appropriate for the couple to have "disclaimer" wills under which the first spouse to die leaves his or her entire estate to the surviving spouse with the surviving spouse having the ability to disclaim any or all of the assets that would pass to him or her. Alternatively, the wills could provide for \$675,000 to pass to a bypass trust with the balance passing outright to the surviving spouse who would have the ability to disclaim. If the disclaimer meets the requirements of a "qualified disclaimer" under Internal Revenue Code Section 2518, including the rule that the disclaimer must be effectuated within nine months of the date of death, any disclaimed assets will pass to a bypass trust under the

deceased spouse's will which takes advantage of the deceased spouse's applicable exemption amount and will not be taxed in the surviving spouse's estate. Since the bypass trust benefits the surviving spouse, the implementation of the disclaimer technique should not present any meaningful economic disadvantages for the surviving spouse.

Therefore, to optimize the use of the decedent's applicable exemption amount, the surviving spouse should, within nine months of his or her spouse's death, determine how much of the \$3,500,000 exemption amount should be utilized and then disclaim the applicable amount so that it can pass federal estate tax free to the next generation. Although a New Jersey estate tax will be imposed on assets in excess of \$675,000 passing to someone other than a spouse, it may be advantageous in many circumstances to pay New Jersey estate taxes on the death of the first spouse so as to significantly reduce the estate taxes that would be due on the death of the surviving spouse. These issues should be discussed in depth with counsel on a timely basis so that all factors can be evaluated and a prudent decision can be made.

It is noted that, for nontax reasons, some estate plans provide for a marital deduction or "QTIP" trust to be utilized instead of an outright distribution to the surviving spouse. In such cases, the desired flexibility for tax planning purposes can be achieved, not through the disclaimer technique, but through a partial QTIP election.

In light of the increase in the federal estate tax exemption to \$3,500,000, existing estate planning documents should be reviewed carefully to make sure that the documents provide sufficient flexibility so that the appropriate decisions can be made on a post-mortem basis taking into account the then applicable tax laws and all other relevant factors.

In addition to the impact on estate

planning, the wider disparity between the federal and New Jersey exemption amounts will also have significant tax implications for estates of New Jersey decedents. In particular, more and more estates will have a total value that is between the New Jersey threshold and the federal threshold so that only a New Jersey estate tax return and not a federal estate tax return will be required.

Several of the key considerations for such estates are outlined below: (1) There are two options for filing the New Jersey estate tax return: the simplified method or the 706 method. The method that is selected could have an effect on the amount of tax due, (2) New Jersey has regulations and guidelines regarding valuation discounts that are more restrictive than under federal law, (3) It appears possible to utilize certain estate administration expenses as deductions for both New Jersey estate tax purposes and for fiduciary income tax purposes which could produce significant tax savings, (4) Since the "706 method" requires a determination of the federal estate tax as if the decedent died on December 31, 2001, there are a number of complex issues resulting from the disconnect between the actual and the deemed date of death and (5) Whether gifts are made within three years of death could be significant under the "simplified method" of reporting; this issue is generally inapplicable under federal estate tax law.

New Jersey practitioners, now more than ever, need to be mindful of both federal and New Jersey estate tax issues for their estate-planning clients. Moreover, even though the percentage of estates requiring federal estate tax returns will diminish as a result of the increased exemption, an ever-growing number of complex issues as well as post-mortem planning opportunities will arise in the context of New Jersey estate tax filings. ■