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Estate Planning

Estate Tax Repeal? Definitely Not in New Jersey

Estate planning documents must provide sufficient flexibility in light of the new New Jersey estate tax

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Since Republicans took control of the House and Senate, the likelihood has increased that the tax cuts passed in 2001, including the repeal of the federal estate tax, will be made permanent. However, even if the federal estate tax is permanently repealed, a New Jersey estate tax will continue to be imposed on New Jersey estates as a result of a recent change in New Jersey's estate tax law.

One component of The Economic Growth and Tax Relief Reconciliation Act passed in 2001 is that the federal estate tax credit for state death taxes is being phased out over a three-year period beginning in 2002.

The Internal Revenue Code of 1986, as amended, provides in §2011(a) that the estate tax owed to the federal government will be credited with the amount of estate taxes actually paid to any state, up to certain limits set forth in §2011(b)(1). EGTRRA added §2011(b)(2), which phases out the state death tax credit by providing that 75 percent of the maximum credit set forth in §2011(b)(1) will be permitted in 2002, 50 percent of the credit will be permitted in 2003, 25 percent of the credit in 2004, and no credit will be allowed in 2005.

Since many state estate taxes, including New Jersey's, are tied to this federal credit, those states will face a loss of revenues as this credit is phased out. New Jersey is among several states that have changed their estate tax laws to prevent this revenue loss.

Prior to the recent revision, New Jersey's estate tax was considered a "sponge" tax, which meant that the New Jersey estate tax was equal to (or soaked up) the maximum state death tax credit permitted under §2011(b).

Thus, for example, prior to the change in the New Jersey estate tax law, if a single individual died in New Jersey in 2003 with a $1.5 million estate (and an applicable exclusion amount equal to $1 million — which is the amount that can pass to anyone without incurring a federal estate tax), the federal estate tax (prestate death tax credit) would have been $210,000, and the estate would have been entitled to a $32,200 state death tax credit (50 percent of the maximum credit set forth in the code). This means that if New Jersey's estate tax had not been revised, the $210,000 estate tax would have been paid as follows: $32,200 to New Jersey and $177,800 to the IRS.

Prior to EGTRRA, assuming the same facts, $64,400 (100 percent of the state death tax credit set forth in the code) would have been paid to New Jersey and $145,600 would have been paid to the IRS. In this example, New Jersey would have collected $32,200 less as a result of EGTRRA, assuming that New Jersey's law had not been revised. By 2005, there would have been no New Jersey tax since under EGTRRA the state death tax credit, and along with it the sponge tax, would then be fully phased out.

The impact of EGTRRA on any state with a sponge tax is clear. Without a change in the law of any sponge-tax state, the revenue stream for that state would totally dry up starting in 2005.

Capping the Credit

New Jersey enacted a new estate tax which is applicable to the estate of any New Jersey resident dying after Dec. 31, 2001. The New Jersey estate tax is effectively "decoupled" from the state death tax credit applicable under the code and provides that the new New Jersey estate tax is equal to what the federal state death tax credit would have been had the decedent died on Dec. 31, 2001 — which requires a calculation of what the federal estate tax would have been on that date.

The applicable exclusion amount on Dec. 31, 2001, was equal to

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$675,000. In 2003, it is equal to $1 million. Under the new law, a New Jersey estate tax will be imposed on assets in excess of $675,000 passing to someone other than a spouse, even though the federal estate tax law permits assets up to $1 million to be transferred to someone other than a spouse.

This creates a situation where, in order to take full advantage of the applicable exclusion and maximize federal estate tax savings, a New Jersey tax will be imposed upon the death of the first spouse to die.

For example, if an individual dies in 2003 with a $1 million estate and he leaves it all to a trust for the surviving spouse and his children using the deceased spouse's applicable exclusion (typically referred to as a "bypass trust" because it is designed to bypass estate taxation in both spouses' estates), no federal estate tax liability would be incurred (assuming no lifetime use of the applicable exclusion).

However, since the taxable estate for New Jersey estate tax purposes exceeds $675,000, a New Jersey estate tax would be due even though there was no federal estate tax. The New Jersey estate tax due on a $1 million estate passing to nonspousal beneficiaries is equal to $33,200. Although this number is relatively small, it becomes larger as the applicable exclusion increases.

For example, in 2004, when the applicable exclusion is increased to $1.5 million, the New Jersey estate tax would be $64,400 if the applicable exclusion were to be fully utilized. In 2006, when the applicable exclusion is increased to $2,000,000, the New Jersey estate tax would be $99,600 if the applicable exclusion were to be fully utilized, and, when the applicable exclusion is increased to $3,500,000 in 2009, the New Jersey estate tax would be $229,200 if the applicable exclusion were to be fully utilized.

Pick Your Poison

New Jersey married couples now need to make an important decision as to what should happen upon the death of the first spouse. Should the applicable exclusion be fully funded to maximize federal estate tax savings, or should the applicable exclusion be under-funded to avoid the imposition of the New Jersey estate tax?

For example, if a spouse dies with $1.5 million today and he leaves only $675,000 (rather than $1 million) to a bypass trust, there would be no federal estate tax or New Jersey estate tax liability. However, the surviving spouse's estate would be increased by an additional $325,000 — the amount that could have been but was not transferred to the tax-exempt bypass trust. If the additional $325,000 in the surviving spouse's estate would result in an increased federal estate tax, it may make sense to pay the New Jersey estate tax and allow the $325,000 to be sheltered from federal estate taxes.

Use of a layered approach helps minimize the risk that a surviving spouse will make inappropriate post-mortem decisions.

The problem with most estate planning documents today is that they lock in a particular result. For example, wills for a husband and wife that require the applicable exclusion amount to be fully funded will provide these clients with no opportunity to decide whether fully funding the deceased spouse's applicable exclusion amount is appropriate.

Thus, it is vital to have estate planning documents that provide the necessary flexibility so that the right decision can be made on a post-mortem basis to either fully fund an individual's applicable exclusion amount and pay the New Jersey estate tax immediately or partially fund an individual's applicable exclusion amount to defer or avoid payment of the New Jersey estate tax.

Flexibility Is the Key

Wills that provide that the residuary estate will pass either outright to the surviving spouse or to a qualified terminable interest property trust for the benefit of the surviving spouse will, if drafted properly, afford individuals and their representatives the flexibility to evaluate these decisions at the time of death, when a much clearer picture of the relevant factors will exist, such as the size of the deceased spouse's estate and the surviving spouse's estate, the tax law then in effect and any expected changes, the surviving spouse's financial circumstances and the amount of the federal and New Jersey estate tax.

For example, a "disclaimer" will that leaves the remainder of the estate to the surviving spouse would also provide the surviving spouse with the ability to disclaim (with the advice of counsel) any or all of the assets that would pass to him. If the disclaimer meets the requirements of a "qualified disclaimer" under the code — which includes 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 exclusion amount.

The surviving spouse would be able to access the relevant factors after the first spouse's death and then be able to decide on the appropriate plan of action with regard to partially or fully funding the deceased spouse's applicable exclusion amount through the use of the disclaimer.

Wills which provide that distributions to the surviving spouse be made for his or her benefit in a QTIP trust can also be drafted to provide for this flexibility. The executors appointed under the deceased spouse's will must make a QTIP election as to the QTIP trust. This is an election to have trust assets qualify for the marital deduction so as to defer estate taxes until the surviving spouse's death.

If the executors elect to have 100 percent of trust assets qualify for the

marital deduction, none of the deceased spouse's applicable exclusion will be used. To take advantage of the deceased spouse's applicable exclusion, the executors should have the flexibility to make a partial QTIP election so that only a portion of the QTIP's assets qualify for the marital deduction. This decision must be made on a timely-filed estate tax return (within nine months, or 15 months with an extension).

Any assets for which no election is made would pass to a bypass trust, rather than a QTIP trust, so as to take advantage of the deceased spouse's applicable exclusion. By using this partial QTIP election technique, the executors under the deceased spouse's will would have the opportunity to review all of the relevant factors discussed above to be able to make a tactical decision as to the appropriate amount to be placed in a trust that uses the deceased spouse's applicable exclusion.

The Layered Approach

While the structure of these wills provides the surviving spouse and the executor with flexibility to make post-mortem decisions to maximize tax savings, it relies on these individuals to make important decisions within a specific time frame. There may be situations where a client does not have confidence that the surviving spouse and the executors will make the appropriate decisions.

As a result, clients may prefer an alternative approach that uses a layered structure. Under this approach, the will creates a first layer equal to the maximum amount that can be sheltered from both the federal estate tax and the New Jersey estate tax (currently $675,000) which would pass to a bypass trust to take advantage of the deceased spouse's applicable exclusion amount.

Since there is no tax disadvantage of locking in the funding of the applicable exclusion to this extent and no post-mortem decisions will be required to shelter this amount, the risk of underutilization of the deceased spouse's applicable exclusion is significantly reduced.

The second layer would consist of the remainder of the estate, and would pass to the surviving spouse, either outright or to a QTIP trust for his benefit, as explained above. Under this approach, the surviving spouse and the executors would need to make the same post-mortem decisions with respect to the second layer that were required to be made with respect to the entire estate under the first approach. Since the decision applies to a smaller amount, however, the consequence of an inappropriate decision is less significant.

For example, assuming a husband dies in 2003 without having used any applicable exclusion during his lifetime, the first layer would be funded with $675,000, and would pass to a bypass trust. This trust would partially fund his applicable exclusion amount and would be exempt from New Jersey estate tax.

The second layer would be funded with the remainder of his estate and would pass to his wife either outright or to a QTIP trust for her benefit. If the second layer passes outright to the wife, she would have the ability to disclaim all or a portion of the outright piece into a bypass trust.

If the will passes the second layer to a QTIP trust, the executors would have the flexibility to make a full or partial QTIP election so that only a portion of the QTIP's assets qualify for the marital deduction.

To Gift or Not To Gift

Planning may also be appropriate for clients with estates that are not subject to federal estate tax but which exceed the New Jersey estate tax threshold. For example, if an older client has assets slightly in excess of $675,000, and is comfortable making lifetime gifts to his beneficiaries, it may make sense for that client to make annual exclusion gifts to get below $675,000 to avoid the New Jersey estate tax.

It is important to remember that although the calculation of the New Jersey estate tax does not include the client's adjusted taxable gifts during life, these gifts are included in the federal estate tax calculation, which will then determine whether a New Jersey estate tax is due.

For example, if the decedent has a $600,000 estate, no federal estate tax would have been due in 2001 and, therefore, no New Jersey estate tax would be due. However, if this individual had made $300,000 of adjusted taxable gifts, his estate would have been subject to a federal estate tax in 2001 (estate is in excess of $675,000). Therefore, a New Jersey estate tax equal to $14,000 (which is based on his $600,000 taxable estate, and not the adjusted taxable gifts) would now be imposed.

Prior to the modification of the New Jersey estate tax, advisers rarely had to take into account the impact of this tax. In light of the new law, however, estate planning documents need to be reviewed carefully to make sure they provide sufficient flexibility to make the most appropriate decisions. ■