An Overview of New Jersey Estate/Trust Tax Considerations

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I. New Jersey "Death Tax" Considerations

In many respects, New Jersey's estate tax situation has improved significantly in the past few years, but for some estates, that promise of change might seem illusory due to the continuation of our complicated inheritance tax structure.

Estate Tax

Until January 1, 2017, New Jersey's estate tax provided that for all persons dying after December 31, 2001, New Jersey would "freeze" the estate tax exemption at $675,000 (that was the then-applicable federal exemption). Thus, for a $5 million estate that would have been fully exempt for federal purposes in 2017, there was a New Jersey estate tax of $391,600.   That disconnect between the federal and State exemptions required drafting to address the desired outcome in estates that likely would be subject to federal tax.

On October 14, 2016, as part of a transportation funding bill, then-Governor Christie approved an act that repealed the New Jersey estate tax effective January 1, 2018. That was phased in: as of January 1, 2017, the exemption amount was increased to $2 million. Then, beginning in January 2018, the tax was eliminated. As a result, New Jersey went from the bottom of the list of states (in terms of estate tax considerations) to the top, as we have no estate tax.

Notably, New Jersey's estate tax applied only to New Jersey residents. If a resident of Pennsylvania resident died owning a vacation home at the New Jersey shore, no New Jersey estate tax would have been due on the Pennsylvania resident's estate. It is important to bear in mind, however, that there could be New Jersey inheritance tax consequences.

Inheritance Tax

New Jersey appears to be one of few remaining states that continues to impose an inheritance tax. See N.J.S.A. 54:33-1 et seq. and the corresponding regulations at N.J.A.C. 18:26-1.1 et seq. New Jersey first enacted the inheritance tax in 1892; since then it has been through several changes (the last major change occurred in 1985).

b. Currently, the law imposes a graduated inheritance (or succession) tax ranging from 11% to 16% on the real or personal property with a value of $500 or more that devolved, by probate or non-probate transfer, to certain beneficiaries.

The key distinction between the New Jersey estate tax and the inheritance tax is that the estate tax, like its federal counterpart, focused on what the decedent owned at death (the initial reporting format was similarly the 2001 federal 706). The inheritance tax, by contrast, focuses on the relationship of the recipient of property transferred at death to the decedent (essentially, the more distant relationship, the greater the tax).

d. The inheritance tax, for New Jersey residents, applies to transfers of real and tangible personal property located in New Jersey at the time of death, as well as transfers of intangible property wherever it is located. The inheritance tax does not apply to real and tangible personal property located outside of New Jersey; it also does not apply to life insurance payable to a <u>named beneficiary</u>.

e. For non-residents of New Jersey, the inheritance tax applies only to the transfer of real and tangible personal property that is located in New Jersey. Thus, a Pennsylvania resident could be subject to inheritance tax on his New Jersey vacation home, even if he would not be subject (as a non-resident) to our estate tax.

2. The inheritance tax is imposed based upon the relationship the transferee bears to the decedent, taking into account the following classes of beneficiaries:

a. Class A: parents, grandparents, spouse, “domestic partner” under N.J.S.A. 26-8A-3 (after July 10, 2004), “civil union partner” (after February 19, 2007), children, adopted children, issue of children or adopted children, step children and mutually acknowledged child (the latter is a unique category defined by the inheritance tax law, N.J.S.A. 54:34-2.1.)

i. All Class A beneficiaries are totally exempt from inheritance tax.

ii. The full exemption for spouses applied to decedents dying after January 1, 1985.

iii. As a matter of State (and federal) case law, the Class A “spouse” includes a spouse who entered into a valid same sex marriage.

iv. The exemption for a “domestic partner” applies to decedents dying after July 10, 2004. New Jersey's Domestic Partnership Act creates a legal status available to opposite-sex couples over age 62. (Before the civil union law came into effect, it also was applicable to same-sex couples.) Sometimes, the potential loss of, or reduction in, retirement benefits for senior couples sometimes makes them reluctant to marry, despite being in a committed relationship.

According to the law’s legislative history, New Jersey recognizes that many individuals choose to live in "important personal, emotional and economic committed relationships with another individual," and that these relationships assist the state in promoting the "financial, physical and emotional health of their participants." The law was intended to encourage private dependencies rather than reliance on state benefits.

To register for a New Jersey domestic partnership, a couple must share a common residence, be engaged in a "committed relationship of mutual caring," and agree to support one another if the need arises. They must also demonstrate existing financial interdependence like a joint mortgage, bank account, or designation of one in the other's will.

v. The exemption for a “civil union partner” applied to decedents dying after February 19, 2007. The civil union law was created at that time to extend rights to same-sex couples. The Civil Union Act (P.L. 2006, Chapter 103) provided that whenever in any law, rule, regulation etc. reference is made to “marriage”, “husband”, “wife”, “spouse” and the like the same shall include a civil union. The civil union concept was supplanted, however, by the full recognition of same sex marriage under State and federal case law.

vi. Accordingly, for inheritance tax purposes, property passing to a surviving spouse or domestic partner is property passing to a Class A beneficiary and is exempt.

vii. The full exemption for all other Class A beneficiaries applies to decedents dying after July 1, 1988.

b. <u>Class C</u>: brother or sister of decedent, wife or widow of decedent's son or husband or widower of decedent's daughter.

i. first $25,000 exempt, then rates range from 11% (on amounts up to $1,100,000) to 16% (on amounts over $1,700,000).

c. <u>Class D</u>: all other transferees

i. tax on transfer of $500 or more with rates ranging from 15% (on the first $700,000) to 16%(amounts over $700,000).

d. <u>Class E</u>: charitable dispositions

i. totally exempt from NJIT

e. What happened to Class B? It included charitable, religious and educational institutions that are now part of Class E. Class B was eliminated in 1963.

New Jersey Tax Lien and Waiver Procedures

New Jersey enforces collection of the inheritance tax (like the former estate tax) by imposing a lien on a decedent's property until the taxes are paid. New Jersey's lien (an unrecorded but fully enforceable claim against the decedent's property) precludes the person holding that property (such as a financial institution or the seller upon the sale of real estate) from transferring that property until the lien is released by the Division of Taxation.

Financial institutions and other transferees face significant consequences for transferring the property without securing release of a lien; the existence of such a lien also becomes a factor in real estate transactions involving property that was owned by a decedent. Fortunately, a number of provisions exist that enable the release of that lien by informal procedure (short of filing an inheritance tax return and waiting for final approval). Bear in mind that the inheritance tax remains a lien on all property of the decedent for a period of 15 years after the decedent's death, unless sooner paid or secured by a bond.

To transfer certain property free of the lien, the executor (or recipient of a non-probate asset, in certain instances) would need the written consent of the Director of the Division of Taxation. The Director's written consent is called a "waiver." Waivers are issued once the return is filed and accepted by the Division of Taxation (and all or taxes are paid).

The waiver procedure was generally the same for the New Jersey estate tax as it is for the inheritance tax. But because the inheritance tax applies both to residents (for the transfers of virtually all property) and to nonresidents (for the transfer of real property and tangible personal property (jewelry, art, antiques etc.) that are located in New Jersey), the nonresident would need an inheritance tax waiver in order to transfer his New Jersey real estate or tangible property.

Generally, a waiver is not required for:

a. Automobiles;

b. Household goods and personal effects;

c. Payments made under pension, profit sharing, bonus or stock purchase plans;

d. Funds held in an account in the name of a funeral director in trust for decedent (advance funeral payments);

e. Real or personal property owned by a partnership in which the decedent had an interest (N.J.A.C. 18:26-11.11);

f. Certain life insurance arrangements, including insurance proceeds payable to a named beneficiary other than the estate or its fiduciaries or defined insurance trusts (N.J.S.A. 54;34-4(b) and (f)).

g. Property not subject to New Jersey Inheritance Tax (See N.J.S.A. 54:34-4; N.J.A.C. 18:26-11.14). By way of example, if the decedent held title to property solely in a fiduciary capacity (for example, if he had been acting as trustee of a third party trust), no waiver would be required to transfer that property to his successor trustee. That outcome is premised on the notion that such property would not constitute part of his own estate, but rather, was being held for others.

New Jersey has adopted number of informal procedures, including the use of a form L-8, that authorize certain recipients to receive property free of the lien by completing required documentation that becomes, in effect, a self-executing waiver. The form L-8 constitutes an affidavit that recites, under oath, facts indicating that the estate (or the asset to be transferred) will not be subject to our inheritance tax. For example, if all assets devolve to a spouse (a Class A beneficiary) such that no New Jersey inheritance tax is due, then the Form L-8 can be used. The form L-8 is submitted to the financial institution holding the account, which if it is satisfied with the conents, may then release the assets in an account free of the lien (the financial institution must then file the executed L-8 with the Division of Taxation). Another form (Form L-9) can be used to seek release of the lien on specified real property. If a need arises to seek release of the lien before the full inheritance tax return is filed, the executor might file the Form L-4, which constitutes a "preliminary" return that might seek the release of the lien regarding certain assets (for example, if the estate's real property is being sold and the lien needs to be released to complete a sale). Finally, New Jersey has a concept called a "blanket waiver" that allows release of up to 50% of the asset in an particular account. Nonetheless, in any estate where the dispositive instrument creates a trust, a New Jersey inheritance tax return must be filed.

New Jersey does not have a "gift tax," but the inheritance tax includes a number of features that apply the tax to transfers made in contemplation of death or that will take effect upon death (N.J.S.A. 54:34-1(a) to (c)) and irrevocable transfers in which the Decedent reserved a lifetime interest (N.J.S.A. 54:34-1.1). These concepts are enforced vigorously by the Division; the latter concept is the focus of a pending litigation, <u>Estate of Mary Van Riper v. Director, Division of Taxation</u>, (Oct. 3, 2018, App. Div., Docket No. A-3024-16T4), with an appeal pending to the Supreme Court, regarding the imposition of inheritance tax to a trust created by a husband and wife with tenancy by the entirety property (that devolved to a niece after the death of both spouses).

Note that inheritance tax returns and payments are due eight (8) months after death (N.J.S.A. 54:35-3) and interest is imposed at the rate of 10% on untimely payments (an exception for various causes, such as claims or litigation, reduces that rate to 6%). New Jersey Surrogates provide a notice to the Division of Taxation upon the filing of probate documents so the Division has a method of tracking the existence of estates.

State Income Taxation of Trusts

Since the 1970s, New Jersey has imposed a “gross income tax” upon individuals as well as estates and trusts. N.J.S.A. 54A:5-3. New Jersey taxes the net gains or income derived through a trust (at the beneficiary level) and the undistributed income or gains of a trust (at the trust level). N.J.S.A. 54A:2-1; N.J.S.A. 54A:5-1(h); and N.J.S.A. 54A:5-3). More than three decades ago, however, the New Jersey Tax Court held that New Jersey cannot tax a trust's undistributed non-New Jersey income if the trustee, assets and beneficiaries are all located outside New Jersey, because in that situation the trust lacks minimum contacts with this State. See Pennoyer v. Dir., Div. of Taxation, 5 N.J. Tax 386 (Tax Ct. 1983); Potter v. Dir., Div. of Taxation, 5 N.J. Tax 399 (Tax Ct. 1983).

Our most recent case is Residuary Trust A (Kassner) v. Dir., Div. of Taxation, 27 N.J. Tax 68 (Tax 2013), aff'd Docket No. 0A-3636-12T1(App. Div. May 28, 2015), which held that undistributed income of a trust created under will of New Jersey domiciliary, but that has an out of state trustee and is administered out of state, is not subject to New Jersey income taxation for out of state income.

Fred Kassner, a New Jersey domiciliary, died in 1998 and created trust under his will. In 2006, the trust had a New York trustee and was administered exclusively outside New Jersey. In that year, the trust owned stock in four S corporations. The S corporations owned New Jersey assets and conducted part of their business in New Jersey. The trust did not make distributions to beneficiaries in 2006. The trust filed a 2006 New Jersey fiduciary income tax return, and paid tax on the portion of S corporation income allocated to New Jersey, but not on the balance of the S corporation income.

The Director of the Division of Taxation noticed a deficiency of $192,370 along with interest and penalties, claiming that the trust was taxable on 100% of its undistributed income. The trustee filed a notice of protest, but the Director's final determination imposed the tax on all income on the grounds that the trust held assets in New Jersey (i.e. because the trust held S corporation stock and the S corporations held New Jersey assets). The trustee appealed to the New Jersey Tax Court.

Relying on its prior decision in Pennoyer v. Taxation Div. Dir., 5 N.J. Tax 386 (1983), the Tax Court granted summary judgment for the trustee, and held that New Jersey could not impose the tax in this case, on the grounds that: (1) the U.S. Constitution bars New Jersey from taxing the undistributed income of a trust if the trustee, assets, and beneficiaries are located outside New Jersey; (2) simply (and incorrectly) using a New Jersey address for filing purposes on a state tax return does not created sufficient contacts with the state for taxation purposes; (3) the creation of the trust in New Jersey and the resultant jurisdiction of the New Jersey courts does not create sufficient contacts for taxation; (4) the trust was not administered in New Jersey and the trustee is out of state, and therefore New Jersey can only tax undistributed trust income if the trust owned New Jersey assets; (5) owning stock in an S corporation does not mean the trust owns the assets of the S corporation for the purposes of determining contacts with the state, and it is not proper to conflate pass-through taxation with ownership of underlying assets; and (6) there are not sufficient constitutional due process contacts with the state to subject the trust to taxation on its out of state income.

Kassner was affirmed on non-constitutional grounds; the court focused on the common law "square corners" doctrine to determine that it would be unfair, under the circumstances, to impose tax: the court found it "unnecessary to adjudicate the constitutional question, because the square corners doctrine clearly bars the Division from imposing the tax on this taxpayer for 2006, based on a change in policy that the Division did not announce to taxpayers until 2011. Moreover, contrary to both its notice assessing the tax and its position before the Tax Court, the Division now concedes that the Trust owns no assets in New Jersey."