SHERMAN WELLS

SYLVESTER & STAMELMAN LLP

www.shermanwells.com

ESTATE PLANNING ESSENTIALS

New Jersey Edition

CONTENTS

<u>WILLS, PROBATE AND INTESTACY</u>

<u>Your Will (or Not)</u>

"Item, I give unto my wife my second best bed with the furniture."

-- Last Will of William Shakespeare

You can thank King Henry VIII for your ability to pass the property that you accumulate during your lifetime to the people you want to receive that property after your death. The Statute of Wills, which was enacted in 1540, made it possible for a landowner to determine who would inherit his land upon his death by permitting devise by **Will**[1]. Prior to the enactment of this law, land would pass by prescribed rules of descent – and only if and when the landowner had competent living relatives who survived him.

We still have rules of descent that apply if you die without a valid Will (i.e., "**intestate**") as a resident of New Jersey. These **intestacy** rules govern what happens to the assets held in the sole name of a New Jersey resident (the "**probate** estate") who dies without a Will on or after March 1, 2005. In the case of a decedent who dies leaving a spouse surviving, those rules are as follows:

1. Spouse survives and no parent or descendant (e.g., child, grandchild, etc.) of the decedent is living: spouse takes 100%.

2. Spouse survives and (A) all of the decedent's surviving descendants are also descendants of the surviving spouse <u>and</u> (B) surviving spouse has no other descendant: spouse takes 100%.

3. Spouse survives and decedent left parents surviving but no descendants: spouse receives (i) the first 25% of the estate (but not less than $50,000 or more than $200,000) and (ii) three-quarters of the balance; the surviving parent or parents receive any balance of the **probate assets**.

4. Spouse survives but (A) decedent left surviving descendants who were <u>not</u> descendants of the surviving spouse (e.g., children from a prior marriage) <u>or</u> (B) all the decedent's surviving descendants are also descendants of the surviving spouse <u>but</u> the surviving spouse has descendants who are not also descendants of the decedent (e.g., again, perhaps children from a prior marriage): spouse receives (i) the first 25% of the estate (but not less than $50,000 or more than $200,000) and (ii) one-half of the balance; the surviving descendants of the decedent receive any balance of the probate assets.

[1] Terms appearing in boldface are defined in the Glossary at the back of this booklet.

For example, the property of a New Jersey decedent who died on or after March 1, 2005, without a Will and with a $1,000,000 probate estate, leaving a spouse, an 18-year-old child from a prior marriage and three minor children from the current marriage, would pass as follows: (i) first $200,000 to the surviving spouse (the ceiling amount from the first 25% of the estate); (ii) one-half of the $800,000 balance (i.e., $400,000) also to the surviving spouse; and (iii) the $400,000 balance to the decedent's four surviving children in equal shares ($100,000 per child). If all four children had been children of the current marriage (and neither spouse had any other children), then the surviving spouse would receive the entire intestate estate. If the decedent left no children surviving but left a surviving spouse and surviving parents, the spouse would receive $200,000 plus three-quarters of the $800,000 balance ($600,000), with the parents equally dividing the $200,000 balance ($100,000 per parent).

Our intestacy laws also have special rules about the division of property. If you were passing property to your children, you might want or expect that property to pass in equal shares based on the number of your children. For example, suppose your Will specifies that your property passes "**per stirpes**" to the next generation and you have three children, one of whom is deceased leaving two children of his own (Family #1) and a second of whom is deceased leaving four children of her own (Family #2). Under those facts, your property would be divided into three equal shares (one for each child), with the two grandchildren in the Family #1 equally dividing their deceased father's one-third share (i.e., one-sixth each) and the four grandchildren in the Family #2 equally dividing their deceased mother's share (i.e., one-twelfth each). The surviving child naturally receives his one-third share, so each of your three children (or their families, if they predeceased you) would be treated equally.

But property that passes by intestacy in New Jersey passes "**by representation**", which can lead to a different result. Using the above example, the result under intestacy would be that surviving child would still receive his one-third share. However, the remaining two-thirds of your estate would be equally divided among all six surviving grandchildren – one-ninth each. So the grandchildren in Family #1 would together receive <u>less</u> than the one-third share that their father would have received (and might have passed to them in turn) had he survived, and the grandchildren in Family #2 would receive <u>more</u> than their deceased mother would have received had she survived.

In short, letting the laws of New Jersey provide you with your estate plan may produce unwanted results. In addition to potentially giving property to the wrong family members (or in the wrong proportions), the intestacy laws provide no sort of express trust that might otherwise be established for any beneficiary. So a minor child would receive all of his or her inheritance upon attaining age 18, with no provisions for his or her property to be invested, disbursed and/or conserved. Furthermore, assets passing to a minor under the laws of intestacy will generally require the appointment of a **guardian** for the minor's property, who will be limited with respect to the use of the funds during the child's minority.

If you have a valid Will, on the other hand, you decide who gets what property, at what future date (or age) and under what conditions.

Another point to keep in mind is that the intestacy laws also provide rules for who can qualify to run your estate. A surviving spouse has first priority, but if there is no surviving spouse or if he or she cannot (or prefers not to) qualify as administrator, other family members are assigned priority by class, depending on who is an "heir" under the intestacy laws. Given that more than one member of the class (e.g., children, parents, etc.) may want to qualify and so control the administration of the estate, the potential for conflict over who gets to be the administrator should be apparent.

In addition, without a Will, anyone who applies to receive **letters of administration** as the administrator of the intestate estate may be required to post a bond – i.e., a kind of insurance policy that protects the estate from an administrator's possible malfeasance – which means that premiums will need to be paid from estate property. Additional documents will also likely need to be filed (and costs incurred) in the course of administering and winding up the intestate estate.

If you have minor children, there is another important non-economic reason to have a current Will in place: in the event you and your spouse die in a common accident (or within a short time of each other), you would want to designate a guardian to care for those minor children until they attain age 18. Doing so does not guarantee that the person appointed will take office, since the designated guardian could decline to undertake that responsibility, or the Court could determine that the person designated was not suitable. But choosing a potential guardian carefully, discussing the appointment with the person chosen and having husband and wife in agreement on the choice are all prudent steps. And having a valid Will that makes the appointment is essential.

Once you have executed your Will (and you should execute only a single original instrument), you have to decide where to put it. You can often leave the Will to be stored in the vault that your attorney maintains. You can also store the Will in a safe place at home, with your other important papers (e.g., deeds, insurance policies, **beneficiary designations**). Or you can also put the Will in a bank safe deposit box. This last option may present some complications for your designated executor or family members after you are gone.

The general bank practice in New Jersey has been to allow surviving family members to remove three things from the decedent's safe deposit box prior to the appointment of an executor or administrator: funeral or burial arrangements, insurance policies with a named beneficiary and the decedent's Last Will and Testament. However, bank mergers and acquisitions have made it increasingly difficult for an estate representative or family member to get access to the safe deposit box contents before **letters testamentary** are issued – which will not happen until the original Last Will has been presented to the **Surrogate**. Appearing at the bank with an original death certificate and safe deposit box key should facilitate access.

Some years ago, keeping your original Will in a bank safe deposit box would have presented a second problem. New Jersey law provided that the contents of a safe deposit box standing in the name of a decedent – individually, jointly or otherwise – could not be released without at least a 10-day notice to the Division of Taxation of the intended delivery of those contents <u>and</u> the retention of sufficient assets to pay any tax and interest that might be assessed on the contents. The statute also provided that the Division had the right to examine the assets of a decedent contained in a safe deposit box, so that an agent would have had to be present at the opening of the box.

Now, however, the Division of Taxation has released a "**blanket waiver**" that authorizes a bank to permit the immediate release of the contents of a safe deposit box without notice to the Division of Taxation or any other tax-related procedure.

<u>KEEP IN MIND</u>:

1. Have a Will
2. Review your Will every 3-5 years and keep it current
3. Keep your Will in a safe place
4. Make sure family members know where to find your Will (and other important documents)

<u>Probate in New Jersey</u>

"*Death is not the* end*. There remains the litigation over the estate.*"

-- Ambrose Bierce

Probate is the process for officially "proving" a decedent's Will. (The word "probate" is related to "probing," as in "testing" or "proving"). Once the Will is accepted as genuine and valid by the appropriate official, an executor can be installed to take over the decedent's economic affairs, pay his or her debts, gather his or her assets and "execute" the instructions contained in the decedent's Will.

In New Jersey, this process usually involves an appearance at the office of the Surrogate (a county official who functions as part judge and part court clerk for the Superior Court) with an original death certificate and the original Will being offered for probate. The designated executor then signs certain papers stating that he or she will faithfully discharge his or her duties, appoints the Surrogate as an agent for the estate to receive legal documents and pays a small fee. The Surrogate's office will then issue to the executor **letters testamentary** – the official instrument that demonstrates that the executor has taken office and has the power to take charge of the decedent's assets and can pay his or her liabilities. (Please note that we have a handout, which can be obtained upon request, explaining an executor's general tasks and obligations in more detail.)

Normally, in New Jersey (but not necessarily in other states), this process is simple, fast and inexpensive. However, if someone <u>opposes</u> the probate of a Will or if the Will is somehow out of the ordinary (e.g., having pages with cross-outs or additional handwriting on an otherwise typed page or pages missing, etc.), the probate process would be much more complicated, perhaps requiring the involvement of the Superior Court.

It is essential to bear in mind that your Will – and the probate process – will only have authority over your "probate estate" – those assets held in your sole name or that are otherwise directed to be added to your estate. The most skillfully drafted Wills might not be effective if all of your assets are held jointly or if those assets are held primarily by one spouse, but the other spouse dies first. Therefore, bear in mind three important rules:

<u>Proper Title to Assets</u>

Unless extraordinary actions are taken after your death, your Will can operate only over property titled in your sole name at your death. Assets titled jointly with right of survivorship or in a "payable on death" (POD) account pass by operation of law <u>outside</u> of probate, and the provisions of your Will have no effect on them.

For example, suppose a husband intends to leave his estate in a trust that provides his wife with all income and certain rights to receive principal distributions, with what remains in the trust at wife's death passing to his children. That **marital trust** plan – and any protection of family assets that it affords the husband's children – will be effective only for those assets held in the husband's sole name – his probate estate. If that couple's assets are held in accounts titled in joint name with right of survivorship, there will be no probate assets to fund the marital trust, since husband's assets will pass to wife outright by operation of law.

<u>Proper Allocation of Assets</u>

Proper title to assets applies also to the allocation of family assets between husband and wife. While the division of property between husband and wife does not need to be equal, having sufficient assets in each spouse's name to permit all available tax advantages (i.e., income, estate and/or generation-skipping) to be effectively used regardless of the order of death is often an important goal.

For example, suppose a couple has $9,000,000 of assets, with all but a few small checking accounts in the husband's name. Husband and wife were careful not to hold all their assets in joint name and took pains to get good estate planning Wills prepared and kept up-to-date. But suppose the wife dies first. There will be little property governed by the terms of the wife's Will, because almost all the family assets are already owned by the husband. The wife's probate estate (which is all that her Will would control) is virtually nonexistent. And while the "**portability**" provisions (discussed below) of the federal Tax Relief Unemployment Insurance Reauthorization and Job Creation Act" (the "2010 Tax Act") might prevent the loss of **federal estate tax** benefits, any potential **generation-skipping tax** benefits are not preserved by making use of portability.

Note that, if the husband had died first, there would not be a similar problem, since he would have plenty of assets to fund the **bypass trust** for the wife. But no one can safely predict the order of death. Therefore, careful asset allocation between married couples is very important.

Moreover, as discussed below, upon death, there is a step-up in the income tax **basis** of a decedent's assets, with assets jointly held with a spouse receiving a step-up for one-half of those joint assets. If – as in the above example – the $9,000,000 of family assets are held disproportionately by the husband, and again wife is the first to die, only the small amount of assets in wife's name get the benefit of that income tax basis step-up. The disproportionate asset allocation between the spouses may again cause a loss of a significant tax benefit.

<u>Don't Forget the Non-Probate Assets</u>

Many of what may constitute your largest assets – e.g., 401(k) plans, IRAs, insurance and annuity policies – pass by beneficiary designation. Those assets can be made part of your probate estate if you name your estate as primary beneficiary to receive the assets upon your death. However, that might not be your intention or (especially with respect to retirement benefits) provide the best tax result. Moreover, having retirement assets pass through your estate might subject them to the claims of your creditors, while having a designated beneficiary that was <u>not</u> your estate might provide a different result.

Given the importance of this category of assets, it is extremely important to coordinate your beneficiary designations with the other elements of your estate plan in order not to waste tax advantages or have unanticipated results. For instance, if you own a large insurance policy on your own life with your spouse named as primary beneficiary and your children (all currently minors) named as secondary beneficiaries and you and your spouse die in an accident in which he or she predeceases (or is presumed to predecease) you, then your children will be the recipients of the insurance proceeds. And regardless of the fact that your and your spouse's Wills contain very well-drafted trusts for your children that provide detailed instructions about the use of your assets for their benefit, the terms of those Wills are irrelevant. The insurance proceeds will be payable to your minor children outright and therefore need to come under the management of a court-appointed guardian and will become the property of the individual beneficiaries as each one attains age 18 – which may not have been your intention at all.

Instead of naming your minor children as secondary beneficiaries, you could have provided that, if your spouse did not survive you, the death benefit would be divided into the appropriate shares for your children and held in the trusts you created for them under the terms of your Will.

You may also have a "**pay on death**" (**POD**) or "**transfer on death**" (**TOD**) bank account or brokerage account. At your death, the assets in those accounts become the property of your designated beneficiary by operation of law – much like a joint account with right of survivorship (JWRT). However, unlike a JWRT account, a POD or TOD account remains entirely under your control during your lifetime; the designated beneficiary has no rights over the account. Since the assets in those accounts pass by operation of law, they are **non-probate assets** that are not controlled by the terms of your Will and need to fit into your total estate plan. Also, you should remain vigilant that the bank or brokerage house continues to record these accounts as POD or TOD. A slip-up that might cause the assets not to pass to the intended beneficiary and instead become part of your probate estate might also upset your estate plan, causing problems and avoidable expenses after you are gone.

KEEP IN MIND:

1. Probate in New Jersey is generally easy and inexpensive
2. Review title to your assets
3. Allocate assets carefully between spouses
4. Consider your non-probate assets when planning

PLANNING WITH TRUSTS

Trust Basics

"Put not your trust in money, but put your money in trust."

-- Oliver Wendell Holmes

A trust is, most simply, a legal relationship between the grantor of the trust and the **trustee** – i.e., the person designated by the grantor to take legal control over certain assets titled in the name of the trust. The economic benefits of the assets in trust are actually enjoyed by the beneficiaries of the trust – those persons intended by the grantor to receive distributions from the trust (or not) depending on the trust provisions.

The trust relationship is usually formalized by: (i) a written agreement executed during your lifetime (an "**inter vivos**" or **"living" trust**), which creates the trust immediately; or (ii) by your Will (a **"testamentary" trust**), which creates the trust only after your death. After the agreement is executed or the Will takes effect – and the trustee accepts office – he or she (or it, since the trustee can also be a banking institution) then controls the trust assets as a fiduciary, with important responsibilities and legal obligations to the beneficiaries of the trust. (Note that, for a **testamentary trust**, the trustee must qualify with the Surrogate and be issued formal **letters of trusteeship**.)

An extremely important decision when considering creation of any kind of trust is the identity of your trustee, who – as the name indicates – needs to be someone you trust. Your spouse may be a possible trustee in many situations, and where a spouse cannot or should not (perhaps for tax reasons) serve as trustee, another family member might be an appropriate choice. Your chosen trustee need not necessarily be financially savvy, since the trustee is able to employ professional help in performing his or her duties (e.g., accountants for income tax return preparation, investment advisors for asset management assistance or banks or trust companies for general administrative assistance) and can formally delegate certain functions, such as investing, to more expert parties.

If you do not want to use a family member or friend as trustee or are unsure about their abilities, a corporate trustee is an option – either serving alone or as co-trustee with your chosen individual or individuals. Although a bank or trust company is likely to have its own **commission** schedule, with fees potentially higher than the statutory fees permitted to individual trustees, it also provides return preparation and investment management as a matter of course and may, in certain cases, be in a better position to carry out fiduciary tasks than available family members or friends. If you have an existing banking relationship, you might inquire about your bank's own trustee services. But make sure that the trust department you choose is a good fit to carry out these important responsibilities – and remains a good fit over time, since the creation of a testamentary trust may not happen until many years later, at your death.

Even if you decide to name one or more individuals as trustee, you might also consider naming a corporate trustee as a successor, perhaps to take office after the death of all available family members or friends. In that way, you have provided for the trustee of your choice into the distant future. In the alternative, you can permit a trustee to choose his or her own successors, although (obviously), in that case, you – as the grantor of the trust – have delegated the responsibility for choosing your trustee to someone else.

The trustee will be entitled to commissions that are either determined by state statute or, in the case of a banking institution, by its rate schedule. Statutory trustee commissions in New Jersey consist of a 6% annual commission on income earned and corpus commissions of two varieties: (i) an annual corpus commission equal to 0.5% of the first $400,000 of corpus value and 0.3% on corpus value in excess of $400,000; and (ii) a termination commission of between 1% and 2%, depending on how long the trust lasted. (The annual corpus commissions increase by 20% for each trustee more than one.) The rates charged by banking institutions are usually higher – although they may offer additional investment services. And, if the trustee is a family member (e.g., the grantor's spouse), those commissions can be waived and not taken.

The trustee has significant fiduciary duties involving administering and investing the trust assets; keeping accurate records; carefully executing the terms of the trust as set forth in the trust agreement; sending and keeping records of "**Crummey**" notices (where needed); and filing necessary tax returns. With respect to their investment duties, trustees are specifically required to invest trust assets "prudently," as determined under the New Jersey Prudent Investor Act. (Please note that we have a handout, which can be obtained upon request, which explains a trustee's general tasks and obligations in more detail.)

Further, and as discussed in more detail below, based on the enactment of the Uniform Trust Code (the "UTC"), which was adopted effective July 17, 2016, trustees of New Jersey trusts are generally required to notify adult beneficiaries of the existence of the trust and keep them reasonably informed about the trust administration.

The UTC also contains a mechanism that allows trustees to protect themselves from later challenges by trust beneficiaries: a beneficiary of a trust may not commence a proceeding against a trustee more than six months after that beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust <u>and</u> informed the beneficiary of the six-month time frame for commencing a proceeding. In order to get that protection, the trustee's report must contain adequate information regarding trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation, a listing of the trust assets, and, if feasible, market values for those assets.

A trust is a separate income tax-paying entity and will file its own annual income tax returns (unless it is a "**grantor trust**" for income tax purposes, in which case the items of income and deduction are included on the income tax return of the grantor of the trust).

Note that, in certain cases, where all the trustees are <u>not</u> residents of New Jersey, the trust holds no New Jersey property and the trust has no New Jersey source income, the trust may not be required to pay New Jersey income tax on its income.

<u>Uses of Trusts</u>

"Learning to trust is one of life's most difficult tasks."

-- Isaac Watts

Trusts are extremely flexible instruments and can be created to serve any number of purposes:

<u>Probate Avoidance</u>

As noted above, probate avoidance in New Jersey may not be particularly important because we have an efficient, streamlined and inexpensive probate process. However, trusts designed to avoid probate may still have a function for residents of other states with less friendly probate procedures or for New Jersey residents who own real property in those less-friendly states (such as Florida), which may have more intense court oversight than New Jersey. Use of revocable trusts to avoid probate in less-friendly states may speed access to certain assets and eliminate or reduce many of the costs associated with heavy court involvement.

However, even with assets held in a probate-avoidance trust, there are still plenty of post-mortem administrative steps that are <u>not</u> avoided – most importantly, the filing of estate tax returns. <u>Avoiding probate does not mean avoiding or reducing estate taxes</u>.

<u>Investment Management and Dispositive Control</u>

Assets can be placed in trust rather than disbursed among family members in order to consolidate them and facilitate investment oversight or to lower administrative costs (e.g., where investment fees might be reduced based on the amount under custody). For example, rather than make gifts of equity in a family business to various family members, to facilitate oversight of the equity and distributions of income or sale proceeds, a family trust often provides an alternative to consider.

In the case of a second marriage, a spouse might want to provide for adequate distributions to maintain the lifestyle of his or her surviving spouse but also ensure that assets are kept safe for the eventual benefit of children from the first marriage. If property passing from the deceased spouse will be owned outright by the surviving spouse, it would be at risk in the event the surviving spouse remarries or squanders the property or leaves it elsewhere in his or her Will or simply invests poorly. Should any of those possibilities be realized, the decedent's children would never receive the assets intended (eventually) for their benefit. Use of a trust to hold assets for the benefit of the surviving spouse instead of allowing those assets to pass outright to him or her is the answer.

<u>Control Assets for the Benefit of a Minor</u>

Minors cannot open bank or brokerage accounts or enter into contracts for investment advice, even if they are old enough to understand what such things are. And minors in New Jersey cease to be minors at age 18. You might well prefer that any assets for the benefit of a minor be held in trust – not just for investment and control purposes during minority but perhaps until some later age. You can prescribe the terms of those trusts, determine how long they will last and specify how funds should be distributed (or not).

<u>Control Assets for the Benefit of an Incapacitated Family Member</u>

Family members suffering from a disability (or chronic substance abuse problems) may not be able to handle assets – and may never be able to do so. They may, in fact – now or in the future – be dependent on public programs that provide oversight and care. In that event, a trust not only is essential for controlling the assets held for the benefit of that family member, but a **"special needs" trust** (discussed below) may be able to provide benefits while not disqualifying the beneficiary from essential public support.

<u>Estate and Gift Tax Avoidance</u>

Avoiding or minimizing estate and gift taxes will be discussed in much more detail below, and the use of trusts is an important aspect of many of the possible avenues by which federal and state estate, inheritance and gift taxes can be avoided or minimized. Two main types of trusts that will be discussed in detail below are: (i) the "bypass" or "**credit shelter" trust**, designed to use some amount of the federal credit against estate tax (and the New Jersey credit when the New Jersey estate tax was in effect); and (ii) the "marital" trust, designed to qualify for the federal deduction from estate tax for the amount of assets placed in a qualifying trust for the benefit of a surviving spouse (as well as the New Jersey deduction when the New Jersey estate tax was in effect).

Yet another common trust can be formed to hold insurance policies on your life. As will be discussed below, all your property – including the proceeds of insurance policies <u>owned</u> by you (regardless of who the named beneficiary is) – is included in your **gross estate** for federal estate tax purposes. However, a life insurance trust can possibly <u>prevent</u> the proceeds of an insurance policy from being included in your gross estate <u>and</u> the gross estate of any surviving spouse. A properly drafted trust agreement establishing a trust that is carefully administered can exclude all proceeds of insurance policies owned by the trust from federal estate tax.

A successful insurance trust requires: (i) a trustee who is not the insured; (ii) a trust agreement that does not give the insured any prohibited power over the policy (of which there are many); (iii) an effective funding mechanism to provide for payment of annual premiums (often by annual gifts to the trust that qualify for the $15,000 **annual exclusion** owing to inclusion of "**Crummey**" withdrawal powers for the beneficiaries); (iv) new policies applied for and owned by the trust or existing policies that are transferred to the trust by the insured more than three years before death; (v) careful administration (e.g., Crummey withdrawal powers may require annual written notice be given to each powerholder by the trustee); and (vi) monitoring of gift tax consequences. Regarding this last aspect, the gift tax consequences of creating and funding an insurance trust require the consideration of the value of any existing policies transferred to the trust (whole life, universal life and variable life policies may have significant cash value for gift tax purposes), as well as the annual funding for premium payments. In short, any contribution into the insurance trust will be a gift that will need to be carefully planned for and possibly reported on a timely filed gift tax return.

The purpose of the life insurance trust will vary with the purposes of the insurance itself. A common variation of insurance trust would hold "second-to-die" insurance – i.e., insurance that would not pay any proceeds until the death of the survivor of a husband and wife. Such policies typically have lower premiums than single life policies, because the joint life expectancy defers the actuarially predicted payoff date. A second-to-die policy would not be useful where the proceeds are needed to maintain the lifestyle of the surviving spouse; however, they are very useful where the intended purpose is to fund anticipated estate tax payments.

Federal estate taxes are – with few exceptions – payable in full nine months from the date of death. If an estate consists largely of illiquid assets (e.g., a business, real estate, partnership interests), the executor may have a hard time finding the cash to make the required tax payment in just nine months. The liquid proceeds received by the insurance trust following the death of the insured would be available to be borrowed by the estate or to purchase illiquid estate assets, and so provide the cash for the tax payment.

Despite the additional effort and attention involved in creating and administering a trust, consider that $5,000,000 of insurance proceeds on a policy owned by a decedent in a 40% federal estate tax bracket would incur $2,000,000 of federal estate tax, leaving $3,000,000 for the decedent's family. If that policy had been held in an effective insurance trust, the decedent's family would receive the entire $5,000,000, unreduced by estate tax.

Asset Protection from Creditors

Along with investment management and dispositive control mentioned above, trusts can be used to protect assets from the creditors of beneficiaries. For example, suppose you wish to leave assets to a child who owns his or her own business, but you are aware that the child's assets are exposed to certain creditors of that business. If you give property to that child outright, you have added to the child's assets available to potential creditors. But if you put that property in trust for the benefit of the child, any potential creditors may not reach inside the trust to get access to those assets. Moreover, in the event of a marriage breakup, the child's spouse may not have access to trust assets. Only assets actually distributed from the trust to the child would be at risk, preserving the property inside the trust for the child's future benefit (or the benefit of the child's own children).

In addition, certain trusts carefully established in states such as Alaska and Delaware can permit the person who creates that trust (the "grantor") also to be the beneficiary of the trust and to keep the assets in that trust safe from certain creditors of the grantor. Those trusts cannot yet be established in New Jersey, although they can be established by New Jersey residents – but with trustees located in the other state.

As "asset protection" trusts, these instruments are still not completely tested. New Jersey residents who have creditor concerns can certainly consider using such trusts – but presumably not with all their assets and certainly not if creating such a trust would defraud any existing creditors. And certain debts – such as child support payments – cannot be avoided in this way. However, in any kind of trust where the grantor is also a beneficiary, the grantor will almost certainly not avoid estate taxes.

Estate taxes – and other wealth transfer taxes – will be discussed in more detail in the following section.

Uniform Trust Code

New Jersey has enacted its version of the Uniform Trust Code (the "UTC"), which contains many provisions that will streamline the administration of trusts under New Jersey law but also imposes some new obligations on trustees to make certain disclosures to trust beneficiaries. Under the UTC, trustees are required to advise certain trust beneficiaries about the existence of the trust and keep these beneficiaries "reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests." Many individuals who have created trusts may find these relatively new requirements objectionable, as they may prefer – for a variety of reasons – that their beneficiaries not know about the existence of trusts for their benefit.

However, the new law also provides that the terms of a trust may override the duty to make disclosures to trust beneficiaries, with certain limitations. If the trust terms expressly so provide, the trustee does not have to make affirmative disclosures regarding the existence of the trust or its administration. However, notwithstanding any provision in the trust to the contrary, the trustee <u>must</u> respond to a request for a copy of the trust instrument or other information reasonably related to the administration of the trust made by a "qualified" beneficiary of the trust who is at least 35 years old. (A "qualified" beneficiary of a trust is generally a current beneficiary of that trust or the person or persons next in line to benefit from the trust after the interest of the current beneficiary has terminated.)

This duty to respond to a beneficiary's request for information regarding a trust's administration does little to change the obligations of trustees under pre-UTC law, because beneficiaries were already entitled to demand that a trustee account for his or her acts and proceedings as trustee. However, any trust that does not include language expressly providing that the <u>existence</u> of that trust is not required to be disclosed to the beneficiaries can no longer remain a "secret" trust.

The UTC took effect on July 17, 2016, but applies to all New Jersey trusts, including those created prior to the law's enactment. If you have one or more existing trusts and would like to discuss how the new disclosure requirements may affect you or your trustees, please contact your estate planning advisor.

<u>KEEP IN MIND</u>:

1. Trusts can be created during life or included in your Will

2. Trusts are extremely flexible and have a multitude of possible uses

3. New Jersey has enacted a form of the Uniform Trust Code that may require trustees to disclose certain trust information to beneficiaries, including the existence of the trust itself

WEALTH TRANSFER AND INCOME TAXES

Your Will is an essential part of your estate plan. But your plan is not as simple as providing for who gets what. An important part of estate planning involves thoughtful tax planning as well – both federal and state.

The federal taxes to consider are the gift tax, estate tax, generation-skipping transfer ("GST") tax and income tax.

The New Jersey taxes to consider are the inheritance tax and the state income tax. Note that the **New Jersey estate tax** has been repealed effective for residents dying January 1, 2018, and thereafter.

New Jersey Taxes

"In this world nothing can be said to be certain, except death and taxes."

-- Benjamin Franklin, letter to Jean Baptiste Le Roy, Nov. 13, 1789

For many years, the main focus of death tax avoidance for New Jersey residents was the federal estate tax. However, the federal estate tax exemption has been raised dramatically by the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017. That exemption has increased from $11,400,000 in 2019 for an individual ($22,800,000 for a married couple) to $11,580,000 in 2019 for an individual ($23,160,000 for a married couple). So the federal estate tax remains a concern only for New Jersey residents with that significant level of wealth or more.

The New Jersey estate tax historically imposed a tax on assets at much lower levels. For years before 2017, assets in excess of $675,000 ($1,350,000 for a married couple) were subject to the New Jersey estate tax. But the estate tax situation in New Jersey changed for 2017 and future years (as discussed below).

New Jersey Estate Tax

On October 14, 2016, Governor Chris Christie signed a bill repealing the New Jersey estate tax in full as of January 1, 2018. In short, the New Jersey estate tax is gone. But with a new administration in Trenton, whether the New Jersey estate tax is permanently gone is subject to question.

As a result, for many clients, the best advice for minimizing the combined effect of any applicable estate taxes may be to have an estate plan that incorporates maximum flexibility at the death of the first spouse – if the family situation is appropriate. In that way, using **disclaimer** planning, a decision could be made at or after the first death (instead of when the instruments are signed) to incur a potential state estate tax now and potentially minimize federal estate tax later, or vice versa.

Disclaimer Planning: Disclaimer planning utilizes Will provisions that permit funding the bypass trust for the benefit of the surviving spouse with an amount that the surviving spouse chooses to disclaim within nine months of the death of the first spouse, allowing a second – and presumably much later – look at the family estate plan. By use of a prudent and timely disclaimer, the bypass trust could – at the election of the surviving spouse – either be funded to the maximum extent (which would likely cause state estate tax to be payable but might minimize federal estate tax at the death of the surviving spouse) or the funding of that trust could be cut back (which could eradicate any state estate tax but might incur higher federal estate tax later). In either case, the assets of the estate would still pass to or in trust for the benefit of the surviving spouse, but the optimal tax situation could be re-assessed at the latest possible date rather than being locked in at the execution of the planning instruments. The repeal of the New Jersey estate tax in 2018 may make this flexible approach even more desirable in the appropriate family situation.

However, for clients with larger estates, it may be more beneficial to forgo the flexibility of a disclaimer plan and simply opt to set up a fully funded credit shelter trust at the first death. This is particularly true when the family can benefit from full utilization of both spouses' generation-skipping tax exemptions. While the federal gift and estate tax exemptions are "portable" (so that, in effect, the surviving spouse may inherit the unused federal estate and gift exemption of the predeceased spouse), the federal generation-skipping tax exemption is not, and a portion of that exemption could be lost if not properly allocated at the death of the first spouse.

Maximum Trust Planning: Disclaimer planning is not appropriate for every family situation. Where estate tax is or appears to be inevitable or for a couple facing an unsettled family situation (e.g., a spouse who might opt <u>not</u> to disclaim), opting for use of a bypass trust required to be funded with the maximum amount allowed by the federal exemption may be preferable. This alternative approach insures that the surviving spouse would receive the full advantage of the available federal estate tax exemption (even if that meant paying some state estate tax) and would also allow more flexibility in the terms of the credit shelter trust for the surviving spouse's benefit (e.g., inclusion of a testamentary **power of appointment** for the surviving spouse, which – owing to the federal rules governing disclaimers – would not be available in a disclaimer trust).

But bear in mind that the dramatically increased federal exemption amount could mean that existing estate plans that utilize maximum exemption formulas have become skewed. For example, if your Will provided that your $11,580,000 estate would pass by formula into a maximum exemption trust for the benefit of the children from your first marriage, with the balance passing to your surviving second spouse, before the Tax Cuts and Jobs Act, the result would have been a trust funded with $5,490,000 (assuming death in 2017) for your children and $5,910,000 for your surviving spouse. After the Tax Cuts and Jobs Act, the trust for the children from your first marriage would be funded with your entire $11,580,000 estate, and your surviving spouse would get nothing.

Or suppose your Will did not provide for maximum use of the federal estate tax exemption but geared the funding formula to the maximum New Jersey estate tax exemption. In 2020, with the repeal of the New Jersey estate tax, the state death tax "ceiling" on funding disappears entirely, so that formula language could cause your entire estate to pass into that trust. In either case, the amount passing into trust (especially in 2020) could be far different than originally intended when your Will was executed.

In short, given the drastic changes in the federal estate tax and the repeal of the New Jersey estate tax, you should review your estate planning documents to see whether updates are needed.

New Jersey Inheritance Tax

The New Jersey inheritance tax is a tax imposed at death on beneficiaries of a New Jersey estate based on the assets each beneficiary receives and was not repealed by the new legislation. However, property received by "Class A" beneficiaries (i.e., spouses, parents, children, grandchildren) and "Class E" beneficiaries (i.e., qualifying charities) is exempt from the tax, which means that many estates do not incur the inheritance tax at all.

Moreover, while New Jersey does not have a gift tax, the inheritance tax includes a "contemplation of death" rule for gifts made within three years of death. That is, if substantial gifts were made within three years of death, those gifts will be presumed made as part of a plan to avoid New Jersey inheritance tax and will therefore be included in the computation of that tax. That presumption can be rebutted if the gifts were not in fact made in contemplation of death as part of the donor's testamentary plan, but the burden of proof is on the taxpayer. (If the gifts made were not "substantial", they may still be subject to tax, but the taxpayer is relieved of the presumption that they were made in contemplation of death.) However, bear in mind the exemptions to the New Jersey inheritance tax: if those gifts were made to a spouse, child, grandchild, parent or qualified charity, they will still remain exempt from the inheritance tax, even if presumed to have been made in contemplation of death and therefore otherwise subject to the computation of that tax.

The New Jersey inheritance tax is due eight months from date of death, and a return (Form IT-R) must be filed if any portion of the estate passes to someone other than a Class A beneficiary. Note that the New Jersey inheritance tax will apply to non-residents who own real estate or tangible property located in New Jersey, based on the value of that property.

Unlike the New Jersey estate tax, the New Jersey inheritance tax has not been changed or repealed. With the repeal of the New Jersey estate tax, if your Will contains one or more small bequests to beneficiaries who are not Class A beneficiaries, you might want to consider alternatives, since even small bequests to non-Class A beneficiaries will cause your estate to incur the costs of preparing and filing a New Jersey inheritance tax return, which otherwise would not be required. The administrative cost of those bequests might outweigh the benefits.

New Jersey Gross Income Tax

New Jersey residents are aware that this state imposes a "gross" income tax – i.e., far fewer deductions from gross income are allowed as compared to the federal income tax. And the basis rules for determining gains or losses on sales tend to follow the federal rules, with some adjustments. As a result, the focus of estate–related income tax planning will be the federal income tax (discussed below).

KEEP IN MIND:

1. New Jersey has repealed its estate tax but has NOT repealed the inheritance tax

2. Although the New Jersey estate tax has been repealed effective January 1, 2018, there is always the possibility that some form of estate tax will be re-enacted

Federal Taxes

"The difference between death and taxes is death doesn't get worse every time Congress meets."

-- Will Rogers

As noted above, the federal taxes that need to be considered for estate-planning purposes are the gift tax, estate tax, generation-skipping transfer ("GST") tax and income tax.

Federal Estate Tax

Planning for the federal estate tax becomes a serious concern if you and your spouse together have assets in excess of $11,580,000 (the amount in 2020 that any individual can pass free of federal estate tax).

The federal estate tax is a tax imposed on all of the property owned or controlled by citizens and other residents of the United States (including resident non-citizens) – the "gross estate" for estate tax purposes. The gross estate includes the current value of homes, proceeds of insurance policies owned by a decedent, cash, stocks, bonds, cars, jewelry, art collections, IRAs, other **qualified plans**, the value of any jewelry or art collections, and all other assets owned or controlled by the decedent, whether located in the United States or elsewhere, as well as the value of any taxable gifts made during life.

However, in addition to the applicable exclusion amount, there are also important deductions available to reduce the estate tax. The most important of these deductions is the **marital deduction** (discussed below) for property passing to, or in certain qualifying trusts for the benefit of, a surviving spouse.

The federal estate tax has also added the concept of "portability". Before 2011, in order not to lose the value of the unified credit of the first spouse to die, that spouse usually had to create a separate trust to hold the unified credit amount (the "bypass" or "credit shelter" trust), with that trust designed to exclude the assets held in trust from the gross estate subject to federal estate tax on the death of the surviving spouse. Through the use of portability, the first spouse to die does not necessarily need to create that "credit shelter" trust but can elect to let his or her surviving spouse use any of his or her unified credit amount that was unused at the first death. However, as discussed below, although portability offers the possibility of simpler estate plans, there are a number of potential pitfalls and drawbacks that need to be taken into account.

And, importantly, if a decedent's federal estate (gross estate plus adjusted taxable gifts) is below the amount that triggers mandatory filing of a federal estate tax return, taking advantage of portability still requires timely filing. That estate tax return may be simpler in form, with estimates used in place of formal valuations for marital and charitable deduction property, but it still must be filed on time and with sufficient information for the IRS to determine the right of the estate to those deductions.

The federal estate tax return (Form 706) is due nine months from date of death. But suppose the tax is due, but a large proportion of your estate consisted of a family business (and you failed to plan in advance for liquidity – e.g., with life insurance). In those circumstances, your executor might find it impossible to realize sufficient cash to pay the tax due at the nine-month due date. In that case, Internal Revenue Code Section 6166 may allow your executor to defer paying some of the federal estate taxes due if the interest in the family business exceeds 35% of your adjusted gross estate. If your estate can satisfy all of the technical requirements that must be met to qualify for deferral, the federal estate tax <u>attributable to the family business</u> may be deferred, with principal and interest on the deferred tax paid over a 14-year period. During the first four years following the due date of the return, only the interest on the deferred tax must be paid. Beginning five years after the return is due, the deferred tax and interest would be payable in equal annual installments over a 10-year period.

<u>Federal Gift Tax</u>

Before the changes brought about by the 2010 Tax Act, the exemption from the **federal gift tax** was only $1,000,000 – far less than the $3,500,000 exemption from the federal estate tax that applied in 2009. Beginning in 2011, the federal estate and gift taxes once again formed a fully "unified" system, and the 2012 Tax Act retained that unified system: for 2020, the federal gift tax exemption is the same $11,580,000 amount as the federal estate tax exemption.

However, the gift tax exemption amount is <u>not</u> a separate additional exemption on top of the $11,580,000 federal estate tax exemption; there is a single $11,580,000 exemption from federal gift and estate tax in 2020. It is important to remember that the federal wealth transfer system is again a unified system – i.e., it governs both lifetime gift transfers and transfers at death, so that the applicable exclusion amount applies <u>both</u> to lifetime gifts and testamentary bequests: $11,580,000.

As a result of this unified system, if you have given away $5,000,000 in taxable gifts during your lifetime and you die in 2020 with $7,580,000 of property, the lifetime gifts used up $5,000,000 of your $11,580,000 lifetime gift tax exclusion amount, and you paid no gift tax; but you also used up $5,000,000 of the credit available against the federal <u>estate</u> tax. Therefore, the $7,580,000 of assets remaining at your death will be fully subject to federal estate tax, to which you could apply the remaining $6,580,000 of applicable credit equivalent, leaving $1,000,000 subject to estate tax at the maximum 40% tax rate.

The important concept to keep in mind is "**taxable gift**". Taxable gifts are gifts that do not qualify for any applicable deduction (e.g., the marital deduction or the charitable deduction) and exceed or do not qualify for the annual exclusion. For instance, a gift of $30,000 to a child may qualify for the gift tax annual exclusion to the extent of $15,000 – but that leaves a taxable gift of $15,000. That $15,000 excess will use some of the donor's applicable exclusion from the gift tax ($11,580,000 in 2020) or, if the donor has already exhausted his or her applicable exclusion, will generate a gift tax that will need to be paid by April 15 of the year following the year in which the gift was made. Since there is only one applicable exclusion for each taxpayer (not a separate one for gift tax and another for estate tax), taxable gifts are included in the taxable estate for purposes of calculating the estate tax. Taxable gifts are <u>not</u> subject to tax again at death; they are simply used in the calculation of the estate tax to ensure proper use of the applicable credit amount.

The 2010 Tax Act also changed the computation of federal gift tax, so that donors who made gifts when the gift tax was imposed at higher rates (e.g., in 2009, when the gift tax rate could reach 45%) are not at a disadvantage – as was the case in past years – compared with donors making large gifts when the gift tax rates are lower. In general, in 2020, if you did not make any taxable gifts before 1977, you can give an amount equal to the difference between: (i) the total of your taxable gifts made before 2020 and (ii) $11,580,000. For example, if you made a $2,000,000 taxable gift in 2009, you can make a further $9,580,000 of taxable gifts in 2020 and not incur federal gift tax. (However, if you actually <u>paid</u> federal gift tax in past years, the computation will be different.)

The new larger federal gift tax exemption also permits larger lifetime gifts, including gifts to **grantor retained annuity trusts** ("**GRATs**"), **qualified personal residence trusts** ("**QPRTs**"), **intentionally defective grantor trusts** ("**IDGTs**"), etc., as discussed below.

Bear in mind that, at present, the larger federal estate and gift tax exemptions are scheduled to "sunset" in 2025 – i.e., revert to the much lower pre-2017 exemption amounts (adjusted for inflation) for 2026 and beyond. However, the IRS has issued a ruling that provides that gifts made when the exclusion amounts are higher will not be subject retroactively to tax when (and if) the exclusion amounts drop down after 2025. Potential donors with sufficient gift-making resources might want to consider making substantial gifts sooner rather than later, as the current high exemption rates may not be with us forever.

In any case, the federal credit amount you have available is only reduced to the extent that you make a "taxable gift". Many gifts will not in fact be taxable gifts at all:

<u>Annual Exclusion Gifts</u>: Gifts having a value of up to $15,000 (the same exclusion amount that applied in 2019) can be given by a donor to <u>each</u> of any number of persons each year without any gift tax consequence. Not even the filing of a federal gift tax return (Form 709) would be required (though in some cases it still might be desirable, depending on the kind of property being given away).

For example, if you have five grandchildren and wish to make gifts to all of them in 2020, you can give up to a total of $75,000 (up to $15,000 each) without any gift tax consequence. If you are married, you can give a total of $150,000 to those five grandchildren (up to $30,000 each) if your spouse consents to "split" gifts with you (i.e., agrees to have half of the gifts that you make treated as having been made by him or her). However, gift-splitting does require the filing of a federal gift tax return (Form 709), which will include your spouse's formal consent to gift-splitting treatment.

The annual exclusion applies most easily to outright gifts. Gifts made in trust <u>can</u> qualify for the exclusion, but special attention must be given to qualifying gifts in trust for that benefit (as discussed below).

<u>Education and Medical Gifts</u>: The Internal Revenue Code also provides a separate, unlimited exclusion from gift tax – i.e., in addition to the $15,000 annual exclusion – for gifts made directly to educational organizations for education and training costs of the beneficiary. And direct payments to medical providers also qualify for this separate exclusion from gift tax.

<u>Gifts to Charity</u>: Gifts that qualify for the charitable deduction from the federal gift tax also do not count as "taxable gifts" that would otherwise reduce your federal applicable credit amount.

The federal gift tax return (Form 709) is due April 15th of the year following the year in which the gift was made.

<u>Federal Generation-Skipping Transfer Tax</u>

Imagine a very wealthy individual who wants to leave his considerable property for his children, grandchildren and succeeding generations. He could leave his property to his children, who could in turn leave the property to their children, and so on down the generational line. But at each generation level, upon the death of the current asset owner, there could be an estate tax that reduces the family wealth.

Instead of opting for that generation-after-generation passing of wealth down the family line, that wealthy individual could leave his property in trust at his death. There would be an estate tax to be paid at that time. But after that one-time tax, the family wealth passes into trusts for the benefit of his children, grandchildren and so on, with no further estate taxation.

The IRS perceived this technique as a significant loophole in the federal wealth transfer laws, so, in 1976, the first federal generation-skipping transfer ("GST") tax was enacted. However, that tax was practically unworkable, so it was repealed and re-enacted in a new form in 1986. That 1986 version of the GST tax – with changes put into effect over the years – is still with us.

The GST tax imposes a flat tax at the highest current federal estate tax rate (40% in 2020) on certain transfers of wealth that "skip" an intervening generation level in which estate tax might have been levied.

For instance, a $100,000 outright gift to a grandchild would qualify for the $15,000 gift tax exclusion, which would allow a corresponding $15,000 exclusion from the GST tax. However, that leaves $85,000 subject to federal gift tax (against which the donor's applicable exclusion could apply to negate that tax) and $85,000 separately subject to the GST tax (against which the donor's exemption from GST tax could apply to negate that tax). If the donor had exhausted his $11,580,000 estate and gift tax exclusion and his $11,580,000 GST tax exemption, then there would be federal gift tax to be paid on the $85,000 subject to tax (a tax of $34,000 at the applicable 40% gift tax rate) <u>and</u> a separate GST tax at the maximum 40% rate, or an additional $34,000. In fact, there is an additional gift tax on the amount of the GST tax paid by the transferor, costing another 40% of the GST tax paid of $34,000, or about $13,600. In other words, the donor would have to spend $81,600 in taxes to pass $100,000 to a grandchild – a total cost of $181,600.

In addition to the $11,580,000 exemption from the GST tax that each individual possesses and the $15,000 annual exclusion that may apply (depending on the form of the gift), there are other exemptions from the GST tax. Most important is the "predeceased child" rule. If, in the above example, the donor's child who was the parent of the grandchild/beneficiary was deceased at the time of the gift, there would be no GST tax incurred (although gift tax would still apply). And irrevocable trusts established prior to September 25, 1985, are "grandfathered" – i.e., so long as those trusts are not substantially changed or added to, they are exempt from GST tax.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), which was signed into law on June 7, 2001, a number of rules regarding the allocation of GST exemption were changed, and those rules need to be considered when doing GST planning, of which the most important may be the "automatic allocation" rules. While these rules were intended (and often do) help taxpayers avoid incurring GST tax, certain common trusts – such as insurance trusts that provide a trust for the surviving spouse, followed by trusts for children that are expected to be distributed to the children during their lifetime – will need to "opt out" of automatic allocation or else possibly waste valuable GST exemption.

The federal GST tax is reported (and any GST exemption allocated) on the federal gift tax return filed for the year in which the generation-skipping transfer was made.

Note also that, unlike the federal estate tax exemption, the GST tax exemption is not "portable" (see the discussion of portability below). That means any unused GST exemption belonging to the first spouse to die does <u>not</u> pass to the surviving spouse for his or her use.

Federal Income Tax

In 2018, the highest federal marginal income tax rate was reduced to 37%. But the Tax Cuts and Jobs Act that reduced that rate also limited the deduction for state and local taxes to $10,000 for married taxpayers filing jointly. As a result, the combined New Jersey and federal marginal income tax rate for joint filers who itemize deductions will approach the simple sum of the two tax rates – the highest federal income tax rate of 37% plus the highest New Jersey income tax rate of 8.97%, or 45.97%.

The combined New Jersey and federal marginal estate tax rate in 2018 was 49.6% – the top New Jersey estate tax rate of 16% plus the top federal rate of 40% after reduction for the New Jersey estate tax, or 33.6%. In 2020, with the repeal of the New Jersey estate tax, only the top federal rate of 40% applies – though only after taking into account the $11,580,000 federal estate tax exemption. Since no federal estate (or gift) tax is payable until all of the $11,580,000 exemption has been expended ($23,160,000 for a married couple), there is a lot of room for estate tax planning before that tax has to be paid – and often paid only once (unless gift tax is payable multiple times before death). But a New Jersey couple with taxable income over $600,000 would pay at the top income tax rates every year.

In short, income tax planning has become more important given the larger federal exemption. And three areas where income tax planning can make a difference are basis considerations, estate reduction and **grantor trust** planning.

Basis Considerations: When considering what property to give away, some thought should be given to the income tax basis of that property. For example, if you have two properties, one of which you plan to give away and the other you plan to retain indefinitely, and if those properties are otherwise equivalent except that one property has a low income-tax basis and the other has a high basis, it is generally better to give the high-basis property. That is because the income tax basis of gifted property is the carry-over basis – i.e., the basis in the donor's hands carries over and becomes the basis in the donee's hands.

The federal income tax rules provide that the income tax basis of property retained until death changes and becomes the value of that property on the date of death. So if a donor has a choice between giving (i) 1,000 shares of ABC Corp. stock with a value of $100 per share and income tax basis of $10 per share or (ii) 1,000 shares of DEF Corp. stock with a value of $100 per share and an income tax basis of $50 per share, it may be better (assuming no other considerations apply) to give away the DEF Corp. stock and hold the ABC Corp. stock. In that way, if the recipient of the DEF Corp. stock wanted or needed to sell it, the capital gain subject to the recipient's income tax would be $40 per share less. The donor could then retain the ABC Corp. stock and, if that stock was included in his or her estate, its basis would change from $10 per share to the (presumably higher) per share value at date of death, reducing the capital gain subject to the estate's income tax (or the income tax of the estate beneficiaries).

The IRS has added basis reporting rules to try to ensure that the basis of assets received by a beneficiary from a decedent's estate are accurately tracked. Executors are now required to send basis information to beneficiaries regarding the decedent's assets that they will (or may) receive from the estate, with that information to be used by the beneficiaries for their own income tax reporting (e.g., for capital gains computation, when the beneficiary sells an asset received from the estate). And even if a decedent's estate is <u>not</u> required to file a federal estate tax return (and so is <u>not</u> subject to the mandatory basis-reporting rules), income tax basis information is so important that some of the normal estate administration work of identifying and valuing a decedent's assets may still be advisable.

Keep in mind that, if the goal of the gift is to reduce the donor's taxable estate, a gift of appreciated assets should take into account the potential capital gains tax cost versus the projected estate tax savings. You might have been better off holding onto the property for the step-up in basis or selecting property with a higher basis for the gift.

There are three caveats to rules governing change in basis at death, however: (i) if the property depreciates in value in the donor's hands, at the donor's death, the rule provides for a "step-down" in basis; (ii) certain property is not subject to the basis change rules at all (e.g., assets in retirement plans); and (iii) certain property gifted to the decedent that comes <u>back</u> to the donor from that decedent within one year of the original gift, which keeps its basis as it was in the hands of the donor <u>before</u> the gift to the decedent.

<u>Estate Reduction</u>: Property that you give away in forms or amounts that are <u>not</u> "adjusted taxable gifts" (and so not added back into your gross estate) obviously reduce your estate subject to federal estate tax. But in addition, giving away income-producing property – whether an adjusted taxable gift or not – means that the income earned by that gifted property no longer belongs to you. That may mean it gets taxed at lower income tax brackets in the hands of the recipient, and it certainly means that the income no longer accumulates in your estate and causes that estate to grow.

<u>Grantor Trust Status</u>: Suppose you set up a trust during your lifetime (and different types of trusts will be discussed in detail below) for your children or grandchildren, and you want the property in the trust to build up over time. However, every income tax payment that the trust makes defeats that intention and reduces the property kept in the trust. If you could relieve the trust from having to pay its own income taxes (which reach the higher tax brackets far more quickly than do the rates for individuals), the trust fund could grow essentially income tax-free, compounding over time. Each income tax payment you make on behalf of the trust would be, in effect, a gift-tax-free contribution to the trust.

In order to get that beneficial tax result, the trust agreement would need to include certain provisions that trigger "grantor trust" status. And you would need to have the funds to pay the income tax on property you no longer own (and be willing to do so). But certain kinds of trusts that are designed to last over many years (e.g., generation-skipping transfer trusts discussed above) might benefit from being grantor trusts. And, with careful drafting, the trust agreement might provide a mechanism for switching off grantor trust status (if ever desired) to provide even more flexibility. Bear in mind, however, that grantor trust status will lapse at the death of the grantor, at which point the trust will have to file its own income tax returns and begin paying any taxes due itself.

Note that, for grantor trusts created after May 8, 2013, the trustee may be given discretionary authority to reimburse the grantor for income taxes paid on trust income <u>without</u> causing the trust to be included in the grantor's estate.

<u>KEEP IN MIND</u>:

1. The current federal estate and gift tax exemption is $11,580,000 and is indexed for inflation

2. The federal system is a unified system: use of exemption against gift tax during life reduces the amount of exemption available against estate tax

3. Federal GST tax is in addition to the gift tax – though some exemptions are available for both

4. When making gifts, remember the annual exclusion and other special exemptions from gift tax

5. Don't forget to keep income tax considerations in mind when planning for estate and gift tax

FEDERAL ESTATE TAX PLANNING

Goal #1 – Provide for Your Spouse

"The sum which two married people owe to one another defies calculation. It is an infinite debt, which can only be discharged through eternity."

-- Johann Wolfgang von Goethe

For a married couple, ensuring that the surviving spouse has sufficient assets to continue living in the proverbial lifestyle to which he or she is accustomed is usually a primary goal. Use of a flexibly drafted bypass trust or portability permits assets to pass to or for the benefit of the surviving spouse and avoid estate tax at both deaths.

But the federal estate tax system also recognizes that the decedent and the surviving spouse were essentially a single economic unit and so permits assets passing to or for the benefit of a surviving spouse to qualify for a deduction from the gross estate (or simply be exempt from tax) – provided that the assets pass in the correct form. The goal of the taxing authorities is to allow such assets to pass free of tax at the death of the first spouse to die but subject the assets to estate tax in the estate of the surviving spouse (or what remains of those assets).

As noted above, the New Jersey inheritance tax simply exempts from that tax assets passing to a surviving spouse. But the federal estate tax takes a different tack: like bequests to a qualifying charity, bequests (in the correct form) to a surviving spouse qualify for a deduction from the taxable estate and pass estate-tax free.

The federal marital deduction permits property left outright to a surviving spouse or in certain kinds of trusts (so-called "**qualified terminable interest property (QTIP) trusts**" or trusts that grant the surviving spouse a broad power to dispose of trust assets, referred to here as "marital trusts") for the benefit of a surviving spouse to be exempt from tax at the death of the first spouse to die. However, at the death of the surviving spouse, property owned by that spouse (including property inherited from the first spouse to die) or remaining in that special marital trust will be subject to federal estate tax.

The federal marital deduction has a number of technical requirements that must be fulfilled, especially with respect to property passing into a marital trust. For instance, in a marital trust, the surviving spouse must receive all the net income, and the trust cannot terminate upon the occurrence of an event other than the death of the surviving spouse. The trust terms cannot, for example, provide that the surviving spouse would lose the benefit of trust income if he or she remarries. For marital deduction planning, we recommend that you consult your attorney to ensure that all of the technical rules are complied with.

If your spouse is not a citizen of the United States, the rules become even more complex. In that case, to the extent your estate exceeds the "bypass" amount and you wish to utilize the federal marital deduction, there is another layer of technical requirements before the marital deduction is available.

In 1988, the rules for the marital deduction for non-citizen spouses (including U.S. resident non-citizens) were changed: the marital deduction is no longer allowed for property passing outright to non-citizen surviving spouses. To qualify for the deduction, that property must instead pass into a trust for the surviving spouse's benefit (a **qualified domestic trust** or "**QDOT**") that complies with certain strict requirements in addition to the usual marital deduction trust requirements for marital deduction trusts.

Also bear in mind that, if asset allocation between the spouses is an issue, it is not so easy to simply make sizeable gifts to your non-citizen spouse in order to ensure that he or she owns sufficient assets to make use of all of applicable credits regardless of the order of death. For couples who are both U.S. citizens, moving assets between the spouses in outright transfers is simple, because those transfers qualify for the marital deduction. And a non-citizen spouse can transfer his or her assets to a citizen spouse, since the marital deduction for transfers to citizens would apply.

However, if a citizen spouse tries to make gifts or transfer title to assets (which is a form of gift-making) to the non-citizen spouse, the limitations on the marital deduction do apply. So the unlimited outright gifting between spouses that citizen spouses can take advantage of is not available when trying to move assets from a citizen spouse to the non-citizen spouse. But one technique for outright gifts is available: instead of the usual annual gift tax exclusion (which is currently $15,000 indexed for inflation), non-citizen spouses can currently receive up to $157,000 per year (as adjusted for inflation) in 2020 outright under a special gift tax exclusion. Therefore, substantial asset-shifting and gift-making can still take place, though it may need to be spread out over several years, depending on the amounts being transferred.

Goal #2 – Don't Waste Federal Applicable Credit

"The waste of plenty is the resource of scarcity."

-- Thomas Love Peacock

Proper title to and allocation of assets between spouses was discussed above, with the goal being – in certain cases – to ensure that each spouse had sufficient assets in his or her own name so that – regardless of the order of death – each spouse could utilize his or her exemption from federal estate tax ($11,580,000 in 2020) to the greatest extent possible.

Consider this scenario: you die in 2020 with $11,580,000 of assets in your name (your spouse also owns has assets valued at $11,580,000). If you leave all your property outright to your spouse, you will pay no federal estate tax or New Jersey inheritance tax. The reason is that your estate passes to a surviving spouse in a way that qualifies for the federal marital deduction and your spouse is a Class A beneficiary for New Jersey inheritance tax purposes and so exempt from that tax. Assume your spouse dies later in 2020 with an estate of $23,160,000 that passes to your children – but has a federal exclusion amount of only $11,580,000. Absent use of "portability" (discussed below), your $11,580,000 exclusion may have been completely wasted, and your spouse's estate would pay $4,632,000 of federal estate tax. Your children receive only $18,528,000.

But there are two ways to avoid the waste of federal exemption on the death of the first spouse: (i) use of a bypass or credit shelter trust (assuming proper title to and allocation of assets between spouses); or (ii) use of the portability provisions of the federal estate tax.

The Bypass or Credit Shelter Trust

If – instead of passing your $11,580,000 outright to your spouse – you had a Will that provided that an amount equal to your federal exclusion amount (i.e., your "credit shelter" amount) passed into a trust for the benefit of your spouse, then, upon your death in 2020 with $11,580,000 of assets, there are no federal death taxes payable, and your estate of $11,580,000 would pass into trust for your spouse.

Upon your spouse's death in 2020, the assets in that trust (if properly drafted) would be ignored for federal estate tax purposes and could pass to the remainder beneficiaries (e.g., your children) without reduction for federal or New Jersey inheritance tax. The estate of your spouse would total only $11,580,000 and would therefore not be subject to federal estate tax. The result is that your children would receive the $23,160,000 of family assets unreduced by federal death taxes. Compared to the total waste of federal exemption amount in the "all to spouse outright" example, your children receive $4,632,000 more.

In short, this kind of "bypass" or "credit shelter" trust is an important, yet fairly uncomplicated, way to avoid federal estate taxes. And note that any appreciation in the value of the assets in the credit shelter trust between the first death and the death of the surviving spouse increases the estate tax savings of the credit shelter trust technique, since more assets are being sheltered from estate tax inside that trust.

Portability

The federal estate and gift system now incorporates the concept of "portability" – the ability of the first spouse to die to pass to the surviving spouse any of his or her unused federal unified credit against the gift and estate tax.

Consider the initial scenario above: you die in 2020 with $11,580,000 of assets in your name (your spouse also owns has assets valued at $11,580,000), and you leave all your property outright to your spouse. Without portability, the result was a tax disaster: your spouse's estate would pay $4,632,000 of federal estate tax. Your children receive only $18,528,000.

However, if your estate elected maximum portability, so that your surviving spouse in effect "inherited" your unused federal estate tax exemption amount of $11,580,000, the federal estate tax would have been eliminated even on the second death (since your spouse would have a full $23,160,000 of federal exemption to shelter that same amount of assets), and your children will that full $23,160,000 amount.

So, in the absence of optimal planning – whether for asset title or allocation or because of a too-simple Will (or none at all) – electing portability (<u>which still requires the timely filing of a federal estate tax return</u>) can save an enormous amount of potential federal estate tax.

However, despite its apparent simplicity, there are some potential drawbacks to portability compared with the creation of a credit shelter trust on the death of the first spouse to die. Instead of relying on portability, the prudent allocation of family assets and use of a Will that incorporates a credit shelter trust can provide the following benefits:

1. Help preserve family assets in the event of a remarriage whether or not family assets are directed away from children. Portability permits a surviving spouse to use the unused exemption of the <u>most recently deceased spouse</u>. In the example given above, you were able to pass along $11,580,000 of unused exemption to your surviving spouse. However, if your surviving spouse remarried a second spouse ("Spouse B"), and Spouse B also predeceased your spouse leaving no portable exemption to your spouse (e.g., because that exemption was used up during life or on bequests to children from a prior marriage), your $11,580,000 of exemption would be lost, since Spouse B was the "most recently deceased spouse" – not you.

2. Help preserve appreciation in family assets from being subject to transfer tax. The bypass trust shelters from estate tax not <u>just</u> the original assets that fund the trust, but any appreciation on, and retained income earned by, those assets also. But again, note the income-tax tradeoff: appreciated assets in the bypass trust get no step-up in basis at the second death; assets held by the surviving spouse do receive a step-up, which – with the additional applicable credit from portability – might yield a better overall net tax result (see "Income Tax Basis Planning" below).

3. Preserve the exemption from the federal generation-skipping transfer tax (discussed above) of the first spouse to die, which is <u>not</u> portable and may be wasted if not allocated to an appropriate trust.

4. Help protect the assets in the credit shelter trust from the creditors of the surviving spouse.

5. Help preserve the assets in the trust for children of the marriage in the event the surviving spouse remarries (in which case that surviving spouse could leave family assets to or in the control of the second spouse or subject to a property settlement in the event of a divorce).

<u>KEEP IN MIND</u>:

1. Use your federal estate and gift tax exemption wisely – don't waste it

2. To prevent waste of that exemption, consider whether a bypass/credit shelter trust is appropriate for you

3. If a bypass/credit shelter trust is not right for you, don't forget the benefits of portability

4. Careful provisions for your spouse can qualify for the marital deduction from estate tax

GIFT PLANNING

Gift Considerations

"We make a living by what we get. We make a life by what we give."

— Winston S. Churchill

Because gift-making for estate planning purposes is such a broad and varied subject area, we will focus attention on only a few critical areas: federal gift tax rules (i.e., because there is no New Jersey gift tax), gift property valuation and purposes of the gift.

Federal Gift Tax Rules

An overview of the federal gift tax was provided above. Three important considerations to bear in mind when deciding when and how (and to whom) to make gifts are:

Unified Tax System: The federal estate tax and the federal gift tax operate as a unified system. That means use of your $11,580,000 federal exclusion by making adjusted taxable gifts during life uses up the exclusion available to offset the federal estate tax at your death.

Annual Exclusion: Adjusted taxable gifts are those gifts above (or that do not qualify for the annual exclusion from gift tax -- $15,000 per person in 2020, whether that person is related to you in any way or not). However, to qualify for annual exclusion treatment, the gift must be a "**present interest**" in the property given. Outright gifts of property are always present interest gifts, because the recipient is given total control and ownership of the gift property. A gift in trust, however, might be a gift that provides insufficient control by the beneficiary over the gifted property or that takes effect only in the future. Such gifts are not gifts of present interests, and so do not qualify for annual exclusion treatment.

One much-used method of making a gift in trust into a present interest for annual exclusion purposes is to include in the trust agreement a withdrawal right (a so-called "**Crummey power**") in some or all the beneficiaries over contributions to the trust. That withdrawal right could be exercised by the beneficiaries or class of beneficiaries, if desired, and would lapse after a reasonable time (i.e., 30 or 60 days). Because a beneficiary has that withdrawal right – even though it is only temporary and eventually disappears – the amount subject to withdrawal is considered a present interest and qualifies for the annual exclusion up to the $15,000 limit.

Other Gift Exclusions: As noted above, in addition to the $15,000 annual exclusion, there is a separate, unlimited exclusion from gift tax for gifts made on behalf of a beneficiary directly to educational organizations for education and training costs. Bear in mind, however, that the gift must be made directly to the institution – not to the beneficiary. Similarly, direct payments to medical providers also qualify for this separate, unlimited exclusion from gift tax. And, while gifts to charity do not technically qualify as "exclusions", charitable gifts made in the proper form to qualifying institutions will be deducted from total gifts made during the taxable year, and so will in effect be exempt from gift tax.

<u>Gift Valuation</u>

The federal gift tax is computed on the value of the gifted property at the date of the gift. As discussed above, in choosing the optimal property to give, income tax considerations may mean that higher-basis property is more advantageous to give away than lower-basis property. Gift tax (and overall estate reduction planning) considerations mean that property you expect to appreciate is more advantageous to give away than property more likely to stagnate in value or – even worse – depreciate. If the gifted property appreciates, the appreciation on top of the gift tax value is <u>not</u> subject to tax – as it would have been if the donor had held onto the property until death. But, again, when evaluating possible gifts, the analysis should take into consideration the potential income tax costs of giving highly appreciated property, since capital gains taxes that may be incurred by the donee could well offset any gift tax advantages.

Additionally, making gifts may allow use of discounting techniques, of which there are several common varieties discussed below. However, bear in mind that, when reporting gifts on a federal gift tax return, the Internal Revenue Service has specific rules about "adequate disclosure" of gift values. The IRS Service cannot revalue a gift after the expiration of the three-year statute of limitations if it is adequately disclosed in the gift tax return. If not, the statute of limitations remains open – just as if you had never filed a gift tax return at all.

<u>Limited Liability Companies and Partnerships</u>: If you have income-producing property (e.g., real property or a family business) that is a candidate for gift-giving, that property can be placed into a **limited partnership** ("**LP**") or **limited liability company** ("**LLC**"). You can then make gifts of "non-controlling" interests in those partnerships or LLCs, and the value of those gifted interests may be subject to discounts (e.g., for lack of control and/or lack of marketability, etc.) for gift tax purposes of perhaps 30-40%. Such discounts can significantly reduce the tax cost of passing the property to one's intended beneficiaries – without sacrificing present control of the partnership or LLC itself.

For example, if the property placed in the LLC or limited partnership is a business that is worth $10,000,000, and you give away a 10% interest, mathematically, the amount of the gift is $1,000,000. However, the discounts available may reduce the value of the 10% gift to $600,000 or $700,000. The amount of the discounts will vary (and may well be challenged by the IRS), but the theory for such discounts is simple: no one would pay $1,000,000 for that partial interest in a business where they do not have control over what happens in the business and the interest is not easily liquidated and turned into cash. Therefore, the real value of a piece of the business is not the mathematical 10% (i.e., $1,000,000), but the smaller price that a real-world purchaser would pay.

There are many types of interests that may qualify for a variety of such discounts. But bear in mind that the IRS can challenge the amount or rationale for any such discount taken; therefore, valuation discounts need to be carefully documented to minimize the risk of IRS challenges (which may occur regardless of precautions). The IRS has been particularly successful in challenging these techniques where the donor retained management control over the partnership or LLC and where the transaction appeared to lack a legitimate business purpose.

Other red flags for the IRS involve; (i) "deathbed" transactions, (ii) partnerships or LLCs administered as though they were the primary donor's personal accounts and (iii) entities funded with only cash and securities (i.e., instead of business interests, real estate or other illiquid assets).

The IRS may regard these discounting techniques with suspicion and may sometimes seem to be targeting family partnerships and LLCs for extra scrutiny. In the past, when used prudently and with careful documentation and administration – including the required relinquishment of control, funding with appropriate assets and the existence of a valid business (not just estate-planning) purpose – taxpayers could reasonably expect to see discounts in the value of their gifts that result in significant gift tax savings. However, the recent Tax Court case of <u>Powell v. Commissioner</u> has raised significant concern among estate planning professionals.

In the <u>Powell</u> case (which involved a number of bad facts for the taxpayer), the decedent contributed funds to a family limited partnership in exchange for a limited partnership interest, made a gift of that partnership interest and then died shortly thereafter. The IRS successfully argued that, because the decedent had the power (in concert with all of the other partners) to dissolve the partnership, that power was sufficient to pull the full value of the limited partnership gift back into the decedent's taxable estate.

The <u>Powell</u> case is not being appealed, so clients who have formed family limited partnerships or LLCs and have made (or plan to make) gifts of partnership or LLC interests need to be aware of the increased risks surrounding such gifts until additional cases shed more light on just how the IRS intends to make use of the <u>Powell</u> ruling.

<u>Qualified Personal Residence Trusts</u>: Consider this example: If your house is worth $3,000,000 (and there is no mortgage) and you give it to your children, you have made a gift of $3,000,000. If you are 60 years old and put the same house in a "qualified personal residence trust" ("QPRT") in January 2020 and retained the right to live in the house for, say, 10 years, and thereafter it passes to your children, then you made a gift of only about $2,100,000. (Note that the value of the gift may vary from month to month, based on the IRS assumed rates of return used to measure

such gifts.) The difference in gift value is due to the 10-year delay in the effective transfer. The IRS recognizes that such delays reduce the value of the gifts made, and those reductions are determined under IRS tables. And the available discount will vary depending on the interest rate assumed by the IRS: in a low interest rate environment, the discounts will be lower; conversely, when those interest rates tick upward, the discount will be higher.

However, for the QPRT to be effective you <u>need</u> to survive the retained interest term of the trust (in the above example, 10 years). And if you do not like the idea of moving from your home under any circumstances, bear in mind that you need not vacate your house after the 10-year term. You could (if you desire <u>and</u> can work out lease terms with the remainder beneficiaries) stay on there as a tenant, paying a fair market rent to your children – which permits you to shift even more of your assets to your children in rent payments. Moreover, you are not locked into living in the house for the retained term of the trust. The house originally contributed can be sold and a new house purchased by the trust, or, if the house is sold and no new residence purchased, the trust can retain the sale proceeds and pay you an annuity for the balance of the term.

The term of the QPRT can vary: the longer the term, the smaller the gift – but the less likely actuarially that you will survive the term. And the income tax basis of the house in the hands of your children will be the same as it was in your hands. Had you held the house until your death, it would have qualified for a step-up in income tax basis. However, the discount in the value of the gift into the QPRT may offer significant transfer tax savings relative to the loss of the step-up in basis.

The QPRT can also be structured so that the house passes into further trust for the benefit of the grantor's children (or other beneficiaries) at the end of the retained term, with that trust designed to be a "grantor trust" so that the rental payments are not taxable income to the beneficiaries.

Note that there are GST complications with QPRTs: GST exemption will be applied to the full value of the trust assets (usually the house) at the time the retained interest ends – <u>not</u> to the discounted value of the gift when the QPRT was funded.

<u>Grantor Retained Annuity Trusts</u>: Similar to at QPRT, a donor can contribute property other than a personal residence to a trust and retain an annuity interest (i.e., a fixed pay-out payable annually) for a term of years, with the property remaining in the trust passing to his or her children or other remainder beneficiaries at the end of the term. If $500,000 is placed in such a trust (a "grantor retained annuity trust" or "GRAT") in January 2020 for a 10-year term, with $25,000 (i.e., 5% of the initial gift) paid to the grantor every year, the value of the gift into the trust for gift tax purposes is not $500,000 but is only about $275,435 – a significant discount. However, for this trust to be successful in its overall goals: (i) the grantor must outlive the term; and (ii) the assets in the trust must appreciate above the chosen pay-out rate. Bear in mind that assets are returning to the grantor ($25,000 per year for 10 years) and <u>must</u> be paid from the GRAT – if not from income then

from the principal of the trust. If the trust assets were to shrink or not outperform the pay-out rate, the grantor might be worse off (from an estate planning perspective) than before the GRAT was created.

As with QPRTs, GRATs are very sensitive to the monthly interest rates set by the IRS and may be more attractive in a low interest rate environment (i.e., because the lower assumed rates may be easier for the GRAT's investments to surpass, thus permitting more property to pass to the remainder beneficiaries). With interest rates (and IRS table rates) subject to change over the short term, the relevant numbers will require special scrutiny.

Multiple GRATs can also be used in sequence – so-called "cascading" or "rolling" GRATs – so that property paid out from one GRAT gets recycled into another.

It may also be possible to create a GRAT that completely eliminates the gift tax value of the transfer – a so-called "zeroed-out GRAT." In a zeroed-out GRAT, if the trust assets outperform the IRS interest tables, then assets left in the trust at the end of the term pass to the beneficiaries free of transfer tax. If the assets fail to outperform the IRS tables, then the grantor will receive all the gifted assets back during the retained term, and the GRAT will have failed to achieve its intended purpose – though the only downside would be the transaction costs involved in creating and running the GRAT. This technique may be especially interesting for clients who have already used up their lifetime gift exemption.

A variation on the GRAT is the grantor retained unitrust ("GRUT"), which also pays an amount to the grantor each year, though the amount paid is not (as with the GRAT) based on the initial value of the property contributed but instead on the value of the property measured from year to year. That annual valuation makes assets that are difficult to value poor candidates for contribution to a GRUT. However, GRUTs offer their own advantages over GRATs (e.g., additional property can be contributed to a GRUT, while GRATs can receive contributions on a one-time-only basis) and have different interest rate sensitivities.

But, of course, before embarking on any kind of valuation-oriented gift plan, you need to consult your tax or estate planning professional and be fully informed about the benefits and risks that may be involved.

"*Freezing" Your Estate*: In addition to discounting the value of the gifts you make, you could also "freeze" the value of assets remaining in your estate that you expect to appreciate significantly (the "Target Asset"). This gift technique involves the careful creation of an "intentionally defective grantor trust" ("IDGT"). The IDGT is a "grantor trust" for income tax purposes (i.e., such that all trust income is taxed directly to the creator of the trust, as discussed above) and would be designed to be funded with a gift of significant liquid assets. The trustee of the IDGT (who would not be the grantor) would then purchase from the grantor the Target Asset for a promissory note. The Target Asset – and its anticipated appreciation – would then be gone from the grantor's estate, replaced by a promissory note that will not appreciate in value.

The IDGT has a number of technical requirements, as well as needing to meet certain economic expectations. For example, the Target Asset sold to the IDGT must not only appreciate for the technique to be successful but should also produce the cash return necessary to make the payments on the promissory note.

In short, as with all the situations covered in this section, you need to discuss your particular needs and circumstances with your tax or estate planning professional. And, if you decide to proceed with a particular estate-tax savings program, you absolutely must fulfill all of its technical and "housekeeping" requirements.

Paying Gift Tax: It may sound counter-intuitive, but in certain circumstances, paying gift tax might provide estate planning benefits. The benefit is not technically in the valuation of the gift but is related to it. The key is that gift tax paid more than three years before death is excluded from your estate, which can make that tax significantly cheaper tax than the estate tax.

For instance, if you have $2,000,000 and make a gift of $1,000,000 on which you pay gift tax at (for the sake of simplicity) a 50% rate, the donees receive $1,000,000, you pay $500,000 in tax and retain $500,000. At your death, that $500,000 is subject to estate tax at 50%, so your beneficiaries receive another $250,000, and $250,000 is paid in estate tax. The beneficiaries receive a total of $1,250,000, while taxes total $750,000.

Had the entire $2,000,000 been held till death, you would have paid $1,000,000 in estate tax at the 50% rate, and the beneficiaries would receive only $1,000,000. The $250,000 difference is owing to the $500,000 of gift tax that was excluded from the taxable estate in the first example.

So, if the property given away was simply going to be subject to estate tax at death anyway, making the gift and paying gift tax – in effect paying the estate tax in advance – could make economic sense. A further benefit is that, as noted above, New Jersey does not impose a gift tax.

Gift Objectives

Aside from just ordinary donative intent, you may have specific purposes for some gifts that require particular techniques. For example:

Gifts to a "Transfers to Minors Account": One simple way to make gifts to minors, who are legally incapacitated to deal with ownership of property, is to establish a **Transfers to Minors account** at a bank or brokerage house and make gifts into that account. The account needs a custodian (who should not be the donor or the minor's parent if estate tax exclusion of the gift amount is intended), and the account assets will become the property of the minor when he or she attains age 21 (or some specified earlier age – i.e., 18, 19 or 20). The custodian will control distributions from the account (if any) for the minor's benefit. Once the minor attains age 21 (or an earlier designated age of distribution), the property in the account must be turned over to him or her – a potential disadvantage when dealing with substantial amounts.

Given the terms governing Transfers to Minors accounts, they may be best suited for smaller gifts anticipated to be expended for the benefit of the minor before he or she attains the distribution age.

Gifts to a Trust for a Minor: A more complex (but often more appropriate) alternative to establishing a Transfers to Minors account is to create a formal trust for the minor. The Internal Revenue Code contains express provisions that allow gifts to certain trusts (sometimes referred to as "Section 2503(c) trusts") for minors to qualify for the $15,000 annual gift tax exclusion, even though those gifts would otherwise not be treated as "present interests". However, such trusts also require the assets to pass to the beneficiary's control at age 21 – although the trust might be drafted such that, if the beneficiary does not actively request an outright distribution within a certain reasonable time after attaining age 21, the assets would remain in trust for his or her benefit. The beneficiary would need to be given a realistic chance to exercise that right; however, he or she might also be persuaded by the possible advantages of the trust to allow that withdrawal right to lapse.

A second alternative is a variation on the Section 2503(c) trust described above. Instead of relying on that Internal Revenue Code section to qualify gifts for the $15,000 annual exclusion, the trust agreement might contain a withdrawal right (a so-called "Crummey power") over contributions to the trust. That withdrawal right could be exercised by the minor's parent, if desired, and would lapse after a reasonable time (i.e., 30 or 60 days). Depending on the amount contributed, some amount of the power might not lapse until some later time when it could do so without gift tax effect (a so-called "hanging power"); however, apart from the amount of possible withdrawal amounts left "hanging," the assets in the trust would not be required to be distributed to the beneficiary outright at any future time unless so desired.

One of the benefits of these "Crummey trusts" is that, unlike custodial accounts or Section 2503(c) trusts, they can be structured for the benefit of multiple beneficiaries. For example, you would be able to create a flexible Crummey trust for the benefit of all your children that would not divide into separate trusts for their individual benefit until the occurrence of a stated event (e.g., the death of the survivor of you and your spouse) or until the children attain a certain age (e.g., until the youngest living child attains age 21).

Gifts for Education: The provisions of the Internal Revenue Code that grant a separate, unlimited exclusion from gift tax – i.e., in addition to the $15,000 annual exclusion – for gifts made directly to educational organizations for education and training costs of the beneficiary have been discussed above. But other educationoriented gift vehicles include education IRAs and Section 529 plans. The latter are income-tax advantaged plans managed and administered by individual states that allow income tax deferral on earnings until withdrawal. In fact, under EGTRRA, withdrawals from such plans after December 31, 2001, for college and graduate school tuition and related expenses will be entirely exempt from federal income tax. Section 529 plans are intended expressly for higher education expenses and may involve penalties for early or unauthorized withdrawals. Also, if the intended beneficiary opts <u>not</u> to attend college, the beneficiary can be changed to another member of the beneficiary's family without penalty – although there may be complications if there are no such eligible family members. Consult your tax or investment professional for more information about education IRAs and Section 529 plans.

The IRS has also ruled that prepaid, nonrefundable tuition paid directly to an educational institution will qualify for the unlimited exemption from the federal gift tax (and, in the case of gifts by grandparents, from GST tax). Bear in mind, however, the risk: the payment must be nonrefundable even if the child (or grandchild) fails to enroll at or leaves the school for any reason.

<u>Gifts for Medical Expenses</u>: Direct payments to providers for certain medical care of third parties (e.g., parents, adult children) also qualify for an exclusion from gift tax. "Medical care" is defined to include not only direct payments for the diagnosis, cure, mitigation, treatment or prevention of disease, but also costs for transportation for and essential to that medical care, for certain qualified long-term care services and for certain medical insurance payments. But bear in mind that, in order to qualify for the gift tax exemption, the payment must be made <u>directly</u> to the medical care provider.

<u>Gifts for Special Needs</u>: If you need to plan for a family member who is disabled or somehow incapacitated and needs to qualify (or remain qualified) for public benefits, you can make gifts to a specialized trust that can supplement the public benefits. However, such a trust will not only require attention to all the usual issues presented in establishing a trust (e.g., gift and/or GST taxes) but will also need to be carefully drafted to avoid disqualifying the intended beneficiary for those crucial state benefits. Such trusts – commonly referred to as "special needs" trusts – would provide benefits in the broad discretion of the trustee in addition to (but expressly not intended to substitute for) public benefits. These trusts could be established during your lifetime or could be testamentary trusts included in your Will.

KEEP IN MIND:

1. The federal estate and gift taxes operate as a unified system – taxable gifts reduce your $11,580,000 exemption

2. Gifts that qualify for the annual exclusion are not taxable gifts

3. To reduce gift values, think about appropriate discount techniques and "freezes"

4. Special situations (e.g., gifts to minors) may require special gift vehicles

SPECIAL PLANNING SITUATIONS

"A goal without a plan is just a wish."

-- Antoine de Saint-Exupéry

Business Succession Planning

If you own your own privately held business, either alone or with business partners, you need to think about a number of important planning issues. For instance, what happens to your interest in the business if you die? Could the business continue? Do you have a partnership, shareholders' or "buy/sell" agreement that specifies what happens to the interest of a deceased shareholder or partner? Is the value of the business a substantial part of your estate, so that liquidity for estate tax payments would be a problem?

For instance, suppose you have a daughter closely involved in a successful family business and a son who is not. That business is very valuable, but you have few liquid assets, so treating your two children equally presents a serious challenge. You might consider equally dividing the business between your children, so that your son gets a part of your business – but requiring him to sell his share to his sister for a promissory note. This technique works so long as the business can produce enough cash to allow your daughter to make payments on the note – although setting the terms of a note to exist in the future (when you don't know about future economic conditions or the condition of your company) can be difficult.

If you are insurable, you might also consider insuring yourself to provide more liquid assets that could be used for your son's benefit. Any insurance policy should almost certainly be held in a trust (as discussed above), and premium payments would need to fit into your overall plan.

These business planning situations vary widely in their circumstances and are too complex for this booklet. You should discuss your particular business situation with your tax or estate planning advisor.

Multiple Marriages

Suppose you have children from a prior marriage, and you have remarried but do not have a prenuptial agreement with your second spouse, who has children of his or her own. You naturally want to provide for your spouse, but you also want to preserve assets for your own children. Obviously, you need a carefully drafted Will that will establish certain trusts.

However, your surviving spouse has certain rights under New Jersey law regardless of what your Will says. For instance, if your Will left nothing to your surviving spouse, that spouse would have the right to elect to take up to one-third of your "augmented estate" (i.e., your probate estate plus certain other property that you may have transferred) – though (in New Jersey) that amount would be reduced by the value of the surviving spouse's own property and the value of any property received as a result of your death (e.g., insurance proceeds, qualified plan benefits, etc.) – the "spousal election" amount. A valid prenuptial agreement could have changed that result, but we are assuming that you did not execute one. (You might enter into a post-nuptial property settlement agreement, but there is some question under New Jersey law that a post-nuptial – as opposed to a prenuptial – agreement would be enforceable.)

Therefore, the easiest solution to your problem is to have a Will that will place an amount of assets into a trust (or perhaps trusts) for your spouse's benefit that – at least – satisfies the spousal election amount. (Bear in mind that the need for a trust in this asset-control situation is independent of the need for any trusts for estate tax savings purposes; however, the same trust or trusts can serve estate tax planning purposes <u>and</u> asset-control purposes simultaneously.) The trust would last for your spouse's lifetime, with the assets remaining at the spouse's death passing to your children (and not to your spouse's children at all – unless you provide for them expressly). However, you need to consult with counsel to make sure that the trust that is contemplated satisfies the elective share rules. For example, a trust that pays all of its net income to the spouse would satisfy the elective share only to the extent of one-half of the value of the assets funding the trust.

<u>Qualified Plans</u>

Qualified plans and other retirement savings vehicles may account for a large portion of your estate and, owing to the income tax advantages they offer, can be more complicated to deal with than other assets.

One important aspect of these plans is that they will be considered "**income in respect of a decedent**" at your death. As such, they will be subject to estate tax, just like any other asset, but also subject to income tax upon distribution from the plan, just as if you had withdrawn the funds yourself. No step-up in income tax basis will apply. However, the recipient of the property (who will be subject to that income tax) will also be entitled to an income tax deduction based on the estate taxes paid, which is intended to mitigate (though may not entirely eliminate) the double tax burden.

Qualified plan assets are subject to many special rules – though careful planning and drafting can permit those assets to be placed in trust and otherwise used in an effective estate plan. For instance, one danger is that imprudent use of those assets to fund a trust can result in premature and immediate acceleration of all the income tax. A correctly drawn trust and beneficiary designation can avoid that expensive result. Also, federal law requires that the participant's spouse be the primary beneficiary of certain types of qualified plans – a result that cannot be changed without the written consent of the spouse. That consent must be carefully documented.

Given the complications presented by qualified plan assets, other assets are better used to fund a "bypass" trust, owing to the built-in income tax cost. And passing qualified assets directly to a surviving spouse can permit that spouse to take measures that increase the income tax deferral available. Therefore, it is not uncommon to have the spouse named as the primary beneficiary of the qualified assets, with a trust named as secondary or contingent beneficiary. In that way, upon the death of the participant, the surviving spouse may have the opportunity to "disclaim" (i.e., officially refuse to accept certain assets – which must be done within nine months of the participant's death and comply with certain other federal and New Jersey requirements) some or all of those assets and allow them to pass into the designated trust if desired. For added flexibility, because of the possible double tax bite on retirement plan assets (i.e., estate and income tax), many clients name a **private foundation**, **donor-advised fund** or favorite charities as contingent beneficiary to avoid estate and income taxes on retirement assets.

While retirement planning is beyond the scope of this booklet, it is important to be aware of the significant changes made by the federal "SECURE Act", effective January 1, 2020. Here are five things to know:

1. For qualified plan participants who die on or after January 1, 2020, the "stretch" provisions that allowed non-spouse beneficiaries to take annual Required Minimum Distributions ("RMDs") over their life expectancy are gone. With certain exceptions, a non-spouse beneficiary of a qualified plan (i.e., pension plan, 401k or IRA) will be required to withdraw the entire plan balance by the end of the tenth year following the year of the plan participant's death (the "10-year rule"). However, there are no longer any annual RMDs under the 10-year rule. So, if withdrawals from the plan are not needed, the plan assets could remain untouched and compounding on a tax-deferred basis for 10 years.

2. "Eligible Designated Beneficiaries" are exempt (in whole or in part) from the 10-year rule. Eligible Designated Beneficiaries are spouses (who will also still be able to make a spousal rollover), disabled or chronically ill beneficiaries, beneficiaries who are not more than 10 years younger than the plan participant and minor children of the plan participant. Plan beneficiaries in those "eligible" classes can still withdraw annual RMDs over their life expectancy. However, in the case of a minor child, once he or she attains the age of majority, he or she is no longer an Eligible Designated Beneficiary and will be subject to the 10-year rule.

3. For plan participants who attain age 70 ½ in 2020 and later years, the starting date for RMDs has been changed. The old rule required RMDs to begin April 1 of the year following the attainment of age 70 ½. The new rule allows RMDs to begin April 1 of the year following the attainment of age 72.

4. Under the old rules, age 70½ was the cut-off for making contributions to traditional IRAs. The new rules allow contributions to an IRA regardless of age, so long as the plan participant (or spouse) has earned income in the year of contribution.

5. Retroactive to the beginning of 2019, eligible expenses for 529 plans have been expanded to include higher education expenses for certain apprenticeship programs and for education loan repayments. However, the amount that can be used for education loan repayment is capped at $10,000 per person, and any such repayment of loan interest will disqualify that interest from the student loan interest deduction for income tax purposes.

The SECURE Act has made significant changes to the retirement distribution (and other) rules that have been in place for years. It may be time to re-think your beneficiary designations and related planning, especially if you have named one or more trusts as beneficiary of your employer's retirement plan, your 401k or your IRA.

In short, income and estate planning with qualified plans is fraught with complications and potential problems. You should consult your tax or estate planning professional before taking any action.

Out-of-State Real Property

If you own real property in another state (e.g., a condominium in Florida or cottage on Cape Cod), those properties may not necessarily complicate your planning – certainly not as much as assets held in another country. However, they will certainly complicate your estate administration to a certain extent. (Note that this result is caused by real or tangible personal property located in a foreign state; a bank account or other intangible property in another state would not cause the same result.) Your executor will likely need to qualify as ancillary personal representative in the state where the property is located and comply with certain the probate procedures in that state – which may not be as inexpensive and streamlined as New Jersey probate.

And probate in certain states may present special problems. Florida, for example, may prevent an executor from qualifying if he or she is not a close family member or a Florida resident.

To avoid out-of-state probate, you might consider placing non-New Jersey real property in a revocable trust during your life, of which you could be the sole trustee. Then, at your death, the successor trustee of the trust would retain control over that real property without the need for dealing with probate procedures in a foreign state.

Another alternative would be to put the property in joint names (with right of survivorship) with the person or persons you would want to receive it at your death. That way, the property would pass to the joint tenants automatically at your death, without the need for probate. Bear in mind, however, that creating a joint ownership situation (especially with someone other than your spouse) may have other consequences that would make it undesirable (e.g., granting immediate ownership rights in the property to the other joint owners and preventing the property from passing in trust under your Will).

Foreign Property, Accounts and Beneficiaries,

Naturalized U.S. citizens need to be careful not to spend too much time in the country of their original citizenship. Many countries will treat you as a resident for income tax purposes if you spend too much time there, and you may also have foreign probate issues with respect to any real property that you own there.

And any offshore bank accounts you maintain will cause you to have present U.S. reporting requirements if the accounts exceed a certain minimal size. If you have a financial interest in or signature authority over (including authority under a **power of attorney**) a foreign financial account, such as a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, the Bank Secrecy Act may require you to report the account yearly to the Internal Revenue Service on FinCEN Report 114, Report of Foreign Bank and Financial Accounts ("FBAR"), which can only be filed online. There are exceptions to the filing requirement, but the account balance that triggers the reporting requirement is relatively low ($10,000), and the penalties for failure to file the appropriate reports are severe. There is also an entirely separate IRS reporting requirement if you had foreign account balances totaling $50,000 on the last day of the tax year or $75,000 at any time during the tax year.

In short, if you own foreign property or hold foreign accounts, you need to consult not only local counsel regarding your real property holding (and foreign accounts), but you should also be consulting with your accountant every year to ensure that your annual foreign account reporting requirements are being met.

U.S.-based trusts with foreign beneficiaries may also run into complications. For instance, until fairly recently, Israeli beneficiaries of certain foreign trusts may have faced no Israeli income tax liability on distributions received. An Israeli law enacted in 2014 changed that situation and imposed a new reporting and taxation regime. Other countries may have similar tax rules or may be in the process of enacting such rules.

If a trust beneficiary does move overseas, the trustee must be informed and should seek counsel not only regarding any U.S. reporting and taxation requirements but also whether there are requirements imposed by the laws of the new country of residence.

Charitable Planning

There are a number of estate planning options available to individuals with charitable interests. Which option you choose will depend on your family situation, your financial situation, your income tax situation and the charities you wish to benefit.

For instance, there are trusts that can be established that would pay one or more charitable beneficiaries an annual amount for a set term or over the course of some measuring life, with the assets remaining after the expiration of the charitable interest payable to some non-charitable beneficiary (a so-called "charitable lead trust"). Or, you could establish a trust that pays some annual amount to a non-charitable beneficiary (including yourself and/or your spouse) for a set term or for life, with the assets remaining after the expiration of the non-charitable interest payable to some charitable beneficiary (a so-called "charitable remainder trust").

Both charitable lead and charitable remainder trusts are bound by many rules and restrictions but may offer income tax advantages and estate planning opportunities. For example, a person holding a large amount of low-basis, low-dividend securities but seeking higher income could sell her securities, pay the capital gains tax and re-invest the net proceeds in a higher-yielding investment. However, the tax bite could be substantial, which would reduce the amount of income that could be produced. Instead, that person might be able to establish a charitable remainder trust funded with those low-basis securities that would be able to defer federal capital gains tax on the sale of those securities and provide an annuity to the donor far larger than either the dividend income produced by the original low-basis securities or the higher yield of the after-tax re-invested securities.

Individuals looking for more permanent charitable funding vehicles might also consider creating and funding a private foundation, which is a privately controlled charitable entity (formed as a trust or a non-profit corporation) that – most typically – receives charitable contributions from the family of the creator and then makes annual contributions (subject to certain minimum distribution rules) to public charities. (Other forms of private foundations can also be established, including operating foundations – i.e., foundations that do not make charitable distributions but actually operate a non-profit business, such as a museum or historic site.) Private foundations are subject to many operating rules and restrictions, and contributions to them are entitled to more limited charitable deduction rules than contributions to public charities. However, private foundations permit long-lasting, private control of charitable assets.

A simpler alternative to creating a private foundation is to establish a donor-advised or philanthropic fund with a **community foundation**, such as the Community Foundation of New Jersey, or with a bank or brokerage house that offers such charitable funds. Contributions to such funds permit significant recommendation rights over the distribution of the charitable contributions, but without many of the restrictions that apply to private foundations.

The charitable income tax deduction and the establishment of charitable entities are some of the most heavily regulated areas into which individuals can venture. If you are interested in establishing any kind of charitable trust or non-profit corporation or even making a substantial charitable contribution in any year, it is essential that you consult your tax or estate planning professional.

<u>Same-Sex Relationships</u>

For same-sex couples contemplating marriage, the news is good for federal tax purposes. In <u>United States v. Windsor</u>, the United States Supreme Court struck down §3 of the Defense of Marriage Act (DOMA) as unconstitutional. Prior to the <u>Windsor</u> decision, the IRS interpreted §3 of DOMA as prohibiting it from recognizing same-sex marriages for purposes of determining the marital status of taxpayers under the Internal Revenue Code. Accordingly, prior to the <u>Windsor</u> decision, the surviving spouse was not treated as the decedent's surviving spouse for marital deduction, portability or other "equal protection" purposes if the surviving spouse was of the same sex as the decedent. After <u>Windsor</u>, for federal tax purposes, the IRS has adopted a general rule recognizing a marriage of same-sex individuals that was validly entered into in a state whose laws authorize the marriage of two individuals of the same sex – even if the married couple is domiciled in a state that does not recognize the validity of same-sex marriages. <u>In short, same-sex couples who were married in a state that recognizes same-sex marriages have the same rights under federal law as any other married couple</u>.

In New Jersey, the situation is still somewhat unsettled. It is clear that civil-union couples (i.e., same-sex couples – or opposite-sex couples where both parties are over age 62 – who have complied with the requirements of the applicable New Jersey statutes) are, since February 2007, entitled to the same rights as married couples with respect to New Jersey state laws. So, for example, if an individual in a same-sex relationship had an estate of $2,000,000 that was being left to that person's partner, that amount would pass free of federal and New Jersey death taxes in 2020 if there was a valid New Jersey civil union.

The New Jersey Supreme Court has declined to enter a stay of a Superior Court ruling that same-sex marriages are valid in New Jersey. Subsequently, then-Governor Christie dropped plans to appeal that Superior Court ruling. As a result, same-sex marriages are currently valid in New Jersey for state tax purposes as well as federal tax purposes. Legislation can be expected to fully clarify the status of civil-union couples (who may need to formally marry in order to take advantage of all federal and New Jersey benefits afforded to married couples) and the recognition in New Jersey of out-of-state marriages of same-sex couples.

With respect to wills and other typical estate-planning instruments, a married same-sex couple would need to take the same planning steps that any other married couple would take. However, if marriage is not an option, estate planning will naturally be more specialized. For example, an individual in same-sex relationship will want to be very sure that any power of attorney or health care directive (see the next section) that names the other as **attorney-in-fact** or **health care proxy** is kept up to date and in current medical records. Family relationships that are presently cordial can change in the midst of emergent situations, and – if a partner lacks the rights afforded by a valid same-sex marriage – each party may need to take extra care that his or her wishes regarding who makes financial and medical decisions will be respected.

Income Tax Basis Planning

The dramatically increased federal exemption amount has removed the need for federal estate tax planning for wealthy individuals whose estates will not exceed $11,580,000 and couples whose combined estates will not exceed $23,160,000. But while estate tax planning may be less important for individuals in that wealth category, income tax planning remains extremely important.

For example, suppose your family wealth is below the combined $22,800,000 that a married couple can pass without incurring federal estate tax. The first spouse to die could leave his or her estate to the survivor outright and free of trust without worrying about the federal estate tax, and all of the surviving spouse's assets would qualify for a step-up in income tax basis at the second death. The simplicity of such an outright bequest can be very appealing.

But suppose the couple is concerned about leaving a large amount to a surviving spouse outright – whether because of worries about possible creditors or subsequent re-marriage or because of concerns that the survivor might be taken advantage of (e.g., by needy children, other relatives, caregivers, etc.) or just to facilitate investment and management of the family wealth (possibly for future generations as well, requiring a trust to which GST exemption could be allocated at the first death). There may be any number of reasons to consider creating a trust for the surviving spouse, entirely aside from estate tax considerations.

But what kind of trust? A credit shelter trust would protect the surviving spouse but would not be needed for estate tax savings and would not permit a step-up in income tax basis at the death of the surviving spouse. Under these circumstances, it might be prudent to consider a trust for the surviving spouse that could qualify for the federal marital deduction if desired at the first death – either created directly or only after a disclaimer by the surviving spouse – even though the value of the assets of such a trust would be included in the taxable estate of the surviving spouse.

The benefits of that marital deduction trust could be two-fold: (i) the federal exemption of the first spouse to die could pass to the surviving spouse (in whole or in part) by means of the portability rules, so that surviving spouse could have as much as $23,160,000 of exemption available to shield assets from federal estate taxation at the second death; and (ii) at the death of the surviving spouse, because the trust assets would be included in his or her estate for federal estate tax purposes (even though we are assuming no federal estate tax would be payable), those assets could a receive a valuable step-up in income tax basis.

So, suppose property with a value and income tax basis of $10,000,000 went into the marital trust at the first death and subsequently appreciated to $15,000,000 over the life of the surviving spouse. At the death of that surviving spouse, that property would receive a new stepped-up income tax basis of $15,000,000, thus erasing potential capital gains tax on $5,000,000 of appreciation when that property is eventually sold.

In short, just because you think the federal estate tax, with its increased exemption amounts, will not apply to you, there may still be worthwhile estate-related tax planning to be done that may help preserve family wealth.

KEEP IN MIND:

1. If you own your own business, plan now for what should happen when you are gone
2. Qualified plan assets may require special planning attention
3. Out-of-state real property or foreign assets may benefit from probate avoidance planning and/or require special tax reporting
4. You have lots of options for charitable giving – during life or by your Will
5. Same-sex couples who choose not to marry need to plan with particular care
6. While the federal estate tax may no longer be a concern in your planning (or even if it is), income tax planning remains important.

HEALTH CARE DIRECTIVES, POWERS OF ATTORNEY AND OTHER MATTERS

"No man is good enough to govern another man without the other's consent."

-- Abraham Lincoln

Living Will, Health Care Proxy and POLST

A **living will** is a set of instructions for your medical care that is intended to be used when you are no longer able to make medical decisions yourself. Most commonly, the living will contains instructions to "pull the plug" – i.e., cease life support and heroic measures once your quality of life has eroded, and there is no hope of recovery. (The living will could, of course, also state the opposite – i.e., to take all heroic measures possible and maintain you on life support regardless of prognosis.)

A complete health care directive – not limited just to the living will set of instructions – may include a health care proxy also, which is a designation of someone (typically a spouse or child) who can make medical decisions for you when you are incapacitated, including decisions for which you left no explicit instructions in your living will. For example, your living will may contain express instructions about what to do in the event you are unconscious and have no hope of recovery from your medical condition. But those instructions may have no application to a situation where you may well recover from your medical condition, but your doctors would like to use an unorthodox or new (but risky) treatment to speed that recovery. Your health-care proxy would be empowered to make the decision about whether to allow that treatment or not, based on his or her understanding of your desires.

Bear in mind that, so long as you are able to make medical decisions for yourself, the health care directive and your health-care proxy are not relevant. You can even verbally revoke a health-care directive. However, without a health-care directive, the courses of action available to your doctors may be constrained by law and/or hospital policy in dealing with your condition if you cannot make decisions yourself.

Bear in mind also that your health care proxy will likely be considered a "personal representative" under the provisions of the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"). In that case, HIPAA would permit only that person to have access to your private medical records. If you wanted anyone else to have that access (e.g., your attorney-in-fact, as discussed below), other steps would need to be taken.

Another, fairly recent, option for medical care planning is a **POLST** – a "Practitioner Orders for Life-Sustaining Treatment" form. Like a living will, a POLST provides medical orders for your care and specifies the kinds of medical treatment that you want or do <u>not</u> want.

But the POLST – unlike a living will/health care proxy – is completed by a physician or advance practice nurse in consultation with you (or, if you are not able, your proxy), is signed by that medical professional and you (or your proxy) and is printed on distinctive paper to make it harder to overlook. And, unlike a living will/health care proxy, if the instructions in the POLST are willfully ignored, the health care professionals involved will be subject to discipline for misconduct, and hospitals and other care facilities will be subject to fines. Criminal charges are also possible for family members who willfully conceal, forge or falsify a valid POLST form.

In short, the instructions in your POLST are much more likely to be carried out than those in a simple living will/health care proxy.

Power of Attorney

A power of attorney is a written instrument that permits another person (your "attorney-in-fact") to deal with your property during your lifetime in the ways expressly stated in the instrument. A power of attorney can be very limited (e.g., to permit someone to sign a deed at a real estate closing that you are unable to attend) or very broad (e.g., permitting virtually any act with respect to your property, including making gifts) or anywhere in between.

If you were incapacitated or could not be located (for instance, after some kind of disaster), your attorney-in-fact could access your accounts, pay your bills, change your investments, sell property, buy property – any action permitted under the terms of the instrument. The power could be effective immediately upon executing the instrument, or it could be delayed until you were actually incapacitated (a so-called "springing power" – because the power "springs" into existence only at a future date or the occurrence of a future event).

The power of attorney should expressly state that it is a "durable power," which means that it remains in existence even if you are incapacitated (when, in fact, it would likely be most desired). However, bear in mind that, upon your death, the power is immediately invalidated. Your attorney-in-fact may be the same person as your executor, but, once you are deceased, the power of attorney is ineffective in allowing that person to deal with your assets.

You should be aware that your attorney-in-fact may face practical problems in getting custodians of your assets (e.g., banks, brokerage houses, etc.) to respect your power of attorney and accept instructions from your attorney-in-fact. Brokerage houses may be reluctant to respect anything but their own forms of power of attorney. You should consider dealing with that possible issue in advance.

In addition, New Jersey is one of the few states to include a period of time after which financial institutions may refuse to act or rely upon a power of attorney. If the power of attorney is first presented more than 10 years after its creation or if it has been unused for a 10-year period, the bank <u>may</u> refuse to act upon it <u>unless</u> the attorney-in-fact is a spouse, parent, or descendant of a parent of the principal. Despite the bank's authority to refuse the power of attorney, there is no actual expiration date on the instrument (unless one is expressly provided). But because a financial institution may refuse to honor a New Jersey power of attorney in favor of a non-family member if it was executed more than 10 years from its proposed use, it would be a good practice to update those instruments to avoid their becoming ineffective.

Moreover, as noted above, unless your attorney-in-fact is also your personal representative for purposes of HIPAA or your power of attorney includes an express waiver, he or she would <u>not</u> have access to your private medical records.

And a word of caution about joint bank and brokerage accounts for lifetime use: although you might assume that a joint account would permit either owner to access the account and write checks on account funds, that might not be the case. The joint account application might require a box to be checked or some other indication made if only one signature is required on checks; otherwise, it could be presumed that <u>both</u> joint owners need to sign checks. In that case, if one joint owner were incapacitated or unavailable, a power of attorney would prove very useful in permitting the other joint owner to access the account, despite what the account records say.

<u>**Organ Donation**</u>

The key to giving organ donation or funeral instructions is to put those instructions in a place where they can be found in a timely manner. Your directions for organ donation – which are extremely time-sensitive and must be executed in a matter of hours or minutes – can be carried on an organ donation card or by checking a box on your driver's license. You can also leave more detailed directions in a letter, but: (i) someone has to know that such a letter exists, and (ii) that letter has to be accessible and delivered in a timely manner.

Do <u>not</u> put your intended organ donation in your Will. A Will is not typically looked at until long after an organ donation must be made.

<u>**Funeral Instructions**</u>

Funeral instructions are less time-sensitive than organ-donation directions. However, the same principles apply: someone has to know that you have written instructions and must know where those instructions are located. Also, you can, in your Will, appoint a person to carry out your funeral wishes – and that person does <u>not</u> need to be your executor nor does your Will need to have been probated. But, as noted above, a Will may not be examined immediately. If you choose to designate a person to carry out your funeral or other disposition wishes (e.g., cremation), that person (or other family members) or your designated executor should know about that instruction and where to locate your Will.

Digital Assets

New Jersey recently adopted the Uniform Fiduciary Access to Digital Assets Act ("UFADAA"). Under UFADAA, a testator, principal of a power of attorney or the creator of a trust (a "user") has the authority to direct the "custodian" of a digital asset (e.g., Facebook, Google, etc.) to disclose or not to disclose to a designated person (e.g., executor, attorney-in-fact, trustee) some or all of that user's digital assets. The authority to access that information could be granted via an online tool provided by the custodian or by express language in the user's Will, Trust Agreement, Power of Attorney or other instrument.

But you should be considering how to deal with your digital assets regardless of the authority granted by UFADAA. Your designated executor or trustee may not be the most computer-savvy person, so how you organize your digital life is important. You may have a number of devices (e.g., desktop computers, laptops, tablets, phones, external hard drives) or a number of social media accounts (e.g., Facebook, LinkedIn, Instagram, etc.) or use online storage sites (e.g., Dropbox, OneDrive, Google Drive) or own valuable cryptocurrency (e.g., Bitcoin), all of which may require a password to access. You may have online bill-paying linked to bank accounts. Someone may need to access some or all of that information, which means that you need to put your passwords and PINs in a secure place that is accessible to the right person, and keep that information updated as passwords change or are added.

KEEP IN MIND:

1. A living will or POLST can provide medical instructions during a last illness; a health care proxy can empower someone to make medical decisions when you cannot and can obtain your medical information if needed

2. A power of attorney can empower someone to make economic decisions for you when you cannot

3. Organ donation instructions need to be found fast

4. You can leave instructions for your funeral or designate someone by your Will to control funeral arrangements

5. Organize your digital information (passwords, PINs, etc.) and have it accessible to the proper person

GLOSSARY

"The language of the law must not be foreign to the ears of those who are to obey it."

-- Learned Hand

Adjusted Taxable Gifts

Net taxable gifts made after December 31, 1976, which are added to the taxable estate in determining the federal estate tax payable. Taking adjusted taxable gifts into consideration in computing the estate tax is required in the federal "unified" transfer tax system, with its single "applicable credit" (see below) applied against both lifetime gifts and at-death transfers.

Annual Exclusion

The ability to give $15,000 (in 2020) per year per donee without having the gift qualify as a taxable gift for federal gift tax purposes. However, the gift will not qualify for the annual exclusion unless it is a gift of a "present interest" (see below).

Applicable Credit

The credit amount applicable against federal estate and gift tax. In 2020, the credit amount translates into the ability to transfer $11,580,000 of wealth without being subject to federal estate or gift tax (scheduled to increase with inflation in future years). But the federal tax system is a unified system, so the same applicable credit amount is applied against taxable gifts during life and the taxable estate at death.

Attorney-in-Fact

The person (or persons) designated in your power of attorney to act as an agent on your behalf – usually for financial matters.

Basis/Stepped-Up Basis

An income tax concept used for measuring capital gain or loss on the disposition of an asset. Basis usually begins as the cost of an asset (e.g., the price you paid for your house), with certain adjustments permissible over time (e.g., an increase in basis for the addition that you built onto your house). At death, the basis of most assets (but not income in respect of a decedent (IRD) assets) included in the federal gross estate receive a step-up in basis: the new basis is the value of the asset at the date of death as determined for federal estate tax purposes. Note, however, that if the basis of the asset at death is lower than the basis in the hands of the decedent before death, the assets receive a step down in basis.

Beneficiary Designation

The instrument by which you designate one or more individuals, trusts or institutions to receive the benefit of a life insurance policy, IRA, retirement plan, "pay on death" (POD) or "transfer on death" (TOD) account upon your death. The designation can often name a primary beneficiary and a contingent beneficiary (in the event the primary beneficiary does not survive you). Unless the designation names your estate as beneficiary, the assets passing to the beneficiary will be non-probate assets (see below) not subject to the terms of your Will.

Blanket Waiver

A provision of the New Jersey inheritance and estate tax laws that permit access to safe deposit boxes without the need for a tax waiver.

By Representation

A method of providing for a distribution to a class of family beneficiaries. For example, a bequest to "my descendants who survive me, by representation", where the surviving beneficiaries are one child, 4 grandchildren of a deceased child and 1 grandchild of a second deceased child would result in child receiving 1/3, and the 5 grandchildren equally dividing 2/3 (i.e., 2/15 each). Compare "**per capita**" and "per stirpes" below.

Bypass/Credit Shelter Trust

A trust designed to avoid federal and (in part) state estate taxes by use of the federal applicable credit. Assets in the trust would escape federal estate tax at both the death of the first spouse to die and at the death of the survivor.

Class A Beneficiary/Class C Beneficiary/Class D Beneficiary

Classifications used for computing the New Jersey inheritance tax – which has not been repealed. Class A beneficiaries (spouse, civil union partners, domestic partners, descendants and ancestors) are not subject to that tax for assets received from a decedent. Class C beneficiaries (brother, sister, spouse of child etc.) have a $25,000 exemption from the tax, but amounts over $25,000 are subject to tax at rates from 11% to 16%. Class D beneficiaries (i.e., anyone else) are subject to tax at either 15% or 16%.

Commissions

Fiduciaries in New Jersey – executors, administrators, trustees and guardians – are entitled to fees set by statute for serving. Banking institutions serving as fiduciaries may have their own commission rate schedules, which may be more or less than the statutory rates.

Community Foundation

A community foundation is a philanthropic institution, contributions to which are treated as having been made to a public charity. Community foundations – as the name suggests – usually serve a geographically defined territory (e.g., city, county, area or state) and may permit contributions to be made to a donor-advised fund (see below).

"Crummey" Power

The power to withdraw funds contributed to a trust, usually for only a limited time, after which the power lapses. The name derives from a U.S. Tax Court case, which resulted in a decision determining that the amount that could be withdrawn by a beneficiary given such a power would be treated as a "present interest" (discussed below) for purposes of the annual exclusion from federal gift tax. Note that some Crummey powers are "hanging powers": since the amount of the right to withdraw can only lapse to the extent of the greater of $5,000 or 5% of the trust principal (the so-called "5+5 rule") in any year without transfer tax consequences, the trust may provide that a gift in excess of that 5+5 amount will lapse only to the maximum extent permitted under the 5+5 rule, with the balance of the power "hanging" over to later years, lapsing to the maximum 5+5 extent each year thereafter.

Disclaimer

The ability to refuse to accept property from a decedent, whether by Will, beneficiary designation or joint ownership. Disclaimers can be used to fix or mitigate mistakes in an estate plan or can be used intentionally to provide flexibility at the first death of a married couple. Disclaimers that comply with federal requirements prevent the "disclaimant" from having made a gift for federal gift tax purposes.

Donor-Advised Fund

A fund administered by a charitable organization (e.g., a community foundation), contributions to which are treated as having been made to a public charity. Often used as an alternative to a private foundation, donor-advised funds (as the name suggests) allow donors to – in effect – direct (but not mandate in a legally binding way) what charitable organizations receive their gift contributions.

Federal Estate Tax

A transfer tax based on the world-wide assets owned or controlled at death by citizens and resident aliens of the United States or on the assets of non-residents located in the United States. As part of a "unified" transfer tax system, the federal estate tax will take into account taxable gifts made by a decedent. An "applicable credit" (see above) equivalent to $11,580,000 in 2020 is available to offset the tax of U.S. citizens and resident aliens. A number of important deductions (e.g., the marital and charitable deductions) are also available to reduce the size of the taxable estate. The federal estate tax is reported on Form 706, required to be filed nine months from the date of death (with extensions for filing available).

Federal Gift Tax

A transfer tax based on the taxable amount transferred as gifts by citizens and resident aliens of the United States (as well as non-resident aliens transferring certain property located in the United States). As part of a "unified" transfer tax system, the federal gift tax will add the amount of lifetime "adjusted taxable gifts" to the federal gross estate in determining the federal estate tax at death. In addition, taxable gifts during life will use up some or all of the $11,580,000 applicable credit amount. Once that credit amount has been exhausted, additional taxable gifts will require the payment of federal gift tax. The federal gift tax is reported on Form 709, required to be filed April 15 of the year following the year in which the gift was made (with extensions available).

Generation-Skipping Transfer Tax

A transfer tax based on the taxable amount transferred as gifts or at death by citizens and resident aliens of the United States, where the transfer "skips" the first generation below the donor or decedent (e.g., the children) and passes to or in trust for a more remote generation (e.g., grandchildren). A separate credit – not necessarily linked to the estate and gift tax credit though very often used in the same transactions as those credits – equivalent to $11,580,000 is available to offset the tax. Special IRS rules are in effect that provide for automatic allocation of the GST exemption, and care must be taken to ensure that automatic allocation is actually appropriate. The GST exemption is allocated and the tax is reported on Form 709, required to be filed April 15 of the year following the year in which the gift was made (with extensions available).

Grantor Retained Annuity Trust/GRAT

A trust intended to make a gift using a discount based on the length (and amount) of the grantor's retained interest. The trust is required to pay an annuity to the grantor for a set number of years at a set rate. If the grantor survives the set number of years, the remainder interest passes to the intended beneficiaries. If not, the trust assets generally revert to the grantor's estate. The investment returns on the assets in the GRAT should exceed the "applicable federal rate" (i.e., the minimum interest rate set by the IRS) for the month of its creation or else the amount of the anticipated trust remainder passing to the beneficiaries at the end of the retained interest term will be disadvantageously reduced. A variation is the "zeroed-out" GRAT, where the retained interest is so large that the gift of the remainder is valued at zero. A "grantor retained unitrust" (GRUT) is also available, where the annual payout to the grantor varies, based on a percentage of the GRUT asset values year-by-year.

Grantor Trust

A trust whose income is includible in the taxable income, and reported on the Form 1040, of the grantor (or, rarely, a third party). Revocable trusts are always grantor trusts, but other trust terms can cause a trust to be a grantor trust in a particular tax year (e.g., the grantor's ability to swap out trust assets for assets of equivalent value). Prudent use of such grantor trust provisions can allow tax-free accumulation of trust assets, since the trust will not be depleted by tax payments.

Gross Estate

The aggregate amount of assets, regardless of where located, of a U.S. citizen or resident alien subject to federal (and state, if applicable) estate tax. The gross estate includes assets under the control of the decedent (e.g., by general power of appointment or under a revocable trust), jointly held assets and assets transferred by gift but over which the donor retained some impermissible power. In determining the amount subject to estate tax, certain deductions are permitted (e.g., the marital and charitable deductions; deductions for debts and expenses of administration) and "adjusted taxable gifts" are added.

Guardian/Guardian ad Litem

A guardian is a fiduciary appointed to take control of the person and/or property of a minor or incapacitated person (the "ward"). (Note that the guardian of the person and the guardian of the property can be entirely different persons or institutions.) A guardian ad litem is a fiduciary appointed for the limited purpose of representing the ward in a court proceeding. Note also that a parent may be the "natural guardian" of a minor child, but, until formally appointed by a court, is not a guardian entitled to take charge of the minor child's property (e.g., an inheritance from a grandparent).

Health Care Proxy

The fiduciary appointed in an advance health care directive or medical power of attorney to make medical decisions when the principal cannot. Although a living will often contains detailed end-of-life instructions, a health care proxy can provide the flexibility to make decisions regarding medical treatments and procedures when those end-of-life instructions would not apply.

Income in Respect of a Decedent (IRD)

While most assets of a decedent receive a step-up in income tax basis at death, certain assets – such as retirement plan assets – do not and are subject to estate tax and, upon receipt, are subject to the same income tax treatment as if the decedent had received those assets during life. However, recipients of those assets receive a deduction based on estate tax paid that somewhat mitigates the income tax liability.

Intentionally Defective Grantor Trust/IDGT

A trust used in a sophisticated "estate freeze" transaction. A grantor establishes a grantor trust (so that any transaction between the trust and the grantor has no income tax consequence), funds the trust with "seed money" and the trust then buys assets from the grantor for a promissory note, with the purchased assets intended to provide the income to pay off the note. The purchased assets are also expected to appreciate, so the grantor has – in effect – swapped out appreciating assets for a note that will not appreciate. Owing to the risks and technical requirements, professional legal counsel is a must.

Inter Vivos Trust

A trust created during life by agreement or declaration (as opposed to a testamentary trust established only after death by Will).

Intestacy/Intestate

Intestacy is the state of dying without a Will (at which point you have died "intestate"). New Jersey law provides for the distribution of any property of a decedent not disposed of by Will (since an improperly drafted Will can inadvertently fail to dispose of some property, in which case the intestacy is only partial). The fiduciary in charge of an intestate estate is referred to as an "administrator" (not "executor").

Letters of Trusteeship

The official document issued by the Surrogate to the trustee of a testamentary trust, indicating that the fiduciary has formally taken office.

Letters Testamentary/Letters of Administration

The official document issued by the Surrogate to the executor of a Will or the administrator of an intestate estate, indicating that the fiduciary has formally taken office.

Limited Liability Company (LLC)

A business organization organized under the laws of New Jersey (or another specific state) that functions with the limited personal liability offered by a corporation but with income passing through the organization to the members for tax purposes (and so not subject to income tax at the corporate level). Can be used to consolidate family assets and allow gift-making at discounted values. Owing to the risks and technical requirements of such gift-making, professional legal counsel is a must.

Limited Partnership (LP)

A business organization organized under the laws of New Jersey (or another state) that functions with limited personal liability for the limited partners (unlike a general partnership, in which all partners share personal liability). Requires at least one general partner – though that general partner can be a corporate entity. As with an LLC, income passes through the organization to the members for tax purposes (and so not subject to income tax at the partnership level). Can be used to consolidate family assets and allow gift-making at discounted values. Owing to the risks and technical requirements of such gift-making, professional legal counsel is a must.

Living Will

A formal instruction left for end-of-life decisions (usually of the "pull the plug" variety). Must be signed and either notarized or witnessed by two witnesses.

Marital Deduction

A deduction available against the federal estate tax for property passing outright to a surviving spouse or in trust for the spouse's benefit – though that trust must include certain provisions or it will not qualify for the deduction. The most common types of trust are the QTIP trust (discussed below) and a trust that provides the surviving spouse with a general power of appointment. Either of those trusts must provide the spouse with all net income for life and cannot terminate the spouse's interest in the trust by any event other than death.

Marital/QTIP Trust

A "qualified terminal interest trust" (QTIP) that provides a deduction from the federal taxable estate for the value of the assets funding the trust. The executor of the estate must elect QTIP treatment, since it will cause the assets in the trust to be included in the taxable estate of the surviving spouse at his or her later death. The QTIP must provide the surviving spouse with all net income for life, may (or may not) provide for distributions of principal, may not include anyone else as beneficiary during the spouse's lifetime and cannot terminate the spouse's interest in the trust by any event other than death.

New Jersey Estate Tax

Prior to January 1, 2018, a transfer tax was levied on the taxable estates of New Jersey residents (but not non-residents) in excess of $2,000,000. The New Jersey estate tax has been repealed for deaths in 2018 and later years.

New Jersey Inheritance Tax

A transfer tax levied on property received from estates of New Jersey residents or, with respect to non-residents, on property physically located in New Jersey. The amount of tax is based on the relationship of the recipient to the decedent (see "Class A Beneficiary/Class C Beneficiary/Class D Beneficiary" above). When levied along with the New Jersey estate tax, only the amount of the higher of the two taxes is paid. The tax is reported on Form IT-R (or Form IT-NR for non-residents) and is due eight months from date of death. The amount subject to tax will include gifts "made in contemplation of death" within the three years prior to the date of death (though gifts to Class A beneficiaries have no tax consequence). The New Jersey inheritance tax has <u>not</u> been repealed.

<u>Non-Probate Assets</u>

Assets that do not come under the control of an executor or administrator because they pass via designation to a named beneficiary (not the estate), such as insurance proceeds or IRA benefits, or to a joint owner by operation of law. These assets are thus not controlled by the terms of the decedent's Will and may require special planning – especially with respect to retirement accounts or qualified plans.

<u>Per Capita</u>

A method of providing for a distribution to a class of family beneficiaries. For example, a bequest to "my descendants who survive me, per capita", where the surviving beneficiaries are one child, 4 grandchildren of a deceased child and 1 grandchild of a second deceased child would result in each descendant receiving an equal one-sixth share. Compare "by representation" above and "per stirpes" below.

<u>Per Stirpes</u>

A method of providing for a distribution to a class of family beneficiaries. For example, a bequest to "my descendants who survive me, per stirpes", where the surviving beneficiaries are one child, 4 grandchildren of a deceased child and 1 grandchild of a second deceased child would result in the child receiving a one-third share (i.e., the share for each child surviving or leaving surviving issue), the 4 grandchildren of the deceased child receiving one-twelfth shares (i.e., the one-third child's share of their deceased parent divided 4 ways) and the single grandchild of the other deceased parent receiving a one-third share (i.e., the one-third child's share of the deceased parent). Compare "by representation" and "per capita" above.

<u>POLST ("Practitioner Orders for Life-Sustaining Treatment"</u>

A formal medical directive that is completed by a physician or advance practice nurse in consultation with you (or, if you are not able, your proxy), is signed by that medical professional and you (or your proxy) and is printed on distinctive paper to make it harder to overlook. If the instructions in the POLST are willfully ignored, fines and penalties might result.

Portability

A fairly recent addition to federal law that permits the unused applicable credit amount of the first spouse to die to be available to the estate of the surviving spouse for federal estate and gift tax (but not generation-skipping transfer tax) purposes. Bear in mind that the applicable credit is only the unused credit of the most recently deceased spouse, so that credit is not aggregated for multiple marriages, and remarriage would erase the carryover credit of a prior deceased spouse if the new spouse also predeceased.

Power of Appointment

A power to dispose of assets held in trust. The power may be limited to a specific class of persons (e.g., descendants) that does not include the powerholder, in which case it is a "limited" power, and its exercise is not treated as a taxable transfer. Or the power may include the power to appoint the assets to the powerholder, his or her estate, his or her creditors or the creditors of his or her estate. In that case, the power is a "general" power, so that: (i) exercise of the power is a taxable transfer; and (ii) assets subject to the power are included in the gross estate of the powerholder at his or her death. Note that a "Crummey" withdrawal power (discussed above) is a general power of appointment, which is important because even the lapse of a general power (and Crummey powers are designed to lapse) within three years of death causes inclusion of the assets subject to the power to be included in the powerholder's gross estate.

Power of Attorney

A document that confers the power on a person (the "attorney-in-fact") or persons to act as agent for the principal, usually in financial matters. (The term also refers to the power itself.) A power of attorney may confer very broad powers on the attorney-in-fact or may be limited to a specific transaction (e.g., sale of a house or purchase of specific shares of stock). The power may be effective immediately or may come into existence only upon the occurrence of a specified event (a "springing" power). The power should generally be a "durable" power – one that survives the principal's incapacity. The power lapses automatically and immediately upon the death of the principal.

Present Interest/Future Interest

Concepts important for federal gift tax: a present interest in transferred property qualifies for the annual exclusion from gift tax; a future interest does not. A present interest refers to the immediate ownership of gifted property or the right to immediate possession. An outright gift is the gift of a present interest (since it results in immediate ownership), as is a gift subject to a Crummey withdrawal right (which gives the right to immediate possession). Any interest that is not a present interest is a future interest.

Private Foundation

A charitable organization qualified as tax-exempt under Section 501(c)(3) of the Internal Revenue Code, usually created by an individual for the pursuit of specific charitable purposes by means of annual grants. Private foundations are subject to a number of specific rules and prohibitions under the Internal Revenue Code (including a required minimum amount of annual grants), are subject to an annual reporting requirement and do not necessarily allow the same income tax deduction for contributions that a public charity does. Nevertheless, for the wealthy, private foundations can provide a charitable vehicle for family interests that can span generations.

Probate

The process by which a Will is accepted as valid and genuine, resulting in the issuance of letters testamentary to the executor(s). In New Jersey, the probate process is usually fast, inexpensive and requires minimal court oversight, with only the involvement of the county Surrogate's office (see below). Bear in mind, however, that disputes over the validity of a Will or irregularities in the document itself can complicate and delay the probate process and require formal proceedings before the Superior Court.

Probate Assets

Assets held in your sole name (not jointly with right of survivorship or passing by designation to a named beneficiary) that are controlled by the terms of your Will (or the intestacy statute).

Qualified Domestic Trust/QDOT

A trust that can qualify for the marital deduction from the federal estate and gift tax when established for a non-citizen spouse. The trust must comply with a number of technical requirements in addition to the usual marital trust terms that are designed to prevent the trust assets from leaving the jurisdiction of the United States and to impose estate tax at the death of the surviving non-citizen spouse.

Qualified Personal Residence Trust/QPRT

A trust designed to transfer a personal residence in a discounted gift transfer. Much like a GRAT or GRUT, a personal residence (or a portion of one) is transferred to a trust, with the grantor retaining the right to reside in the home for a stated number of years. Upon the expiration of the term, the house passes as provided in the trust instrument, possibly in further trust. Because the grantor retained a number of years of residence, the gift amount is reduced by the value of that retained interest. The grantor must outlive the retained-interest term and may continue to live in the house after the term upon payment of fair market rent.

Qualified Plan

A retirement plan funded with pre-tax dollars, distributions from which are subject to income tax. Qualified plans are subject to a number of technical requirements regarding contributions, distributions and beneficiary designation (e.g., formal written consent is necessary to prevent a spouse from having rights to plan proceeds). After the death of the participant, distributions will be income in respect of a decedent (see above) for the designated beneficiary.

Special Needs Trust

A trust established for an incapacitated beneficiary during life or by Will that provides for the supplemental needs of the beneficiary, without disqualifying the beneficiary from receiving needed public benefits for maintenance and support.

Surrogate

In New Jersey, the county public official in charge of admitting Wills to probate and issuing letters testamentary to executors, letters of administration to administrators and letters of trusteeship to testamentary trustees (among other duties). In the event of a controversy regarding a Will or any irregularity (e.g., missing pages), the Surrogate is prohibited from acting, and further proceedings must occur in the Superior Court.

Taxable Gift

A gift in excess of, or which does not qualify for, the annual exclusion from federal gift tax. If the taxable gift does not qualify for the marital or charitable deduction, it will utilize some portion of the donor's available applicable exclusion amount, or, if the applicable credit has been exhausted, will generate a gift tax.

Testamentary Trust

A trust whose terms are contained in a Will and which does not come into existence until the death of the testator. (Compare "inter vivos trust" above.)

Transfer on Death (TOD) or Pay on Death (POD) Account

An account established at a banking institution that permits the owner to name a beneficiary to receive the balance of the account assets upon the death of the owner. Unlike a joint account with right of survivorship, the designated beneficiary has no rights with respect to the account until the death of the owner, who retains complete control. Assets in a TOD or POD account pass as non-probate assets (but subject to federal estate and New Jersey inheritance taxation as part of the owner's gross estate).

Transfers to Minors Account

A custodial account created under a New Jersey statute and set up for a single minor with a single custodian (who generally should not be the donor). Assets in the account may be used for the benefit of the minor, and any remaining assets will be distributed to the minor upon attaining age 21 (or some earlier age over age 18, if provided by the donor). Note that making a gift to a Transfers to Minors Account and naming yourself as custodian will cause the account assets to be included in your gross estate for federal estate tax purposes if you die before the account is distributed because you retained impermissible control over the gifted assets. A similar problem can arise if the minor's parent is the named custodian.

Trustee

The fiduciary designated to control the administration, investment and distribution of trust assets. May be one or more individuals or a corporate banking institution. If there are more than two trustees in office, they must act by majority rule (unless the trust instrument provides otherwise). An individual trustee need not have any special expertise, since he or she will be entitled to hire accounting help and financial and legal advice as needed and can formally delegate certain actions to an expert non-trustee.

Will

The legal document by which you may leave binding directions regarding the distribution of the property you own in your sole name (or that is subject to your control) at your death. Pursuant to state law, the instrument must be signed by you and (in New Jersey) witnessed by two witnesses. It is also prudent (but not required) to have a "self-proving" affidavit attached to the Will, also signed by the testator and the witnesses and acknowledged by a notary public. (The self-proving affidavit will prevent the witnesses from needing to be located when the Will is offered for probate.)

This booklet was prepared by James Mohoney, with editorial assistance from other members of the Tax and Trusts & Estates Practice Group at Sherman Wells Sylvester & Stamelman LLP. If you have questions, please contact any of the attorneys in our Group. Nothing in this booklet should be relied upon as legal advice in any particular matter.

210 Park Avenue
Florham Park, NJ 07932
973-302-9700

www.shermanwells.com

1185 Avenue of the Americas
New York, NY 10018
212-763-6464