New Jersey Law Journal
STATEWIDE LEGAL AUTHORITY SINCE 1878
An ALM Publication
DECEMBER 28, 2015 NJLJ.COM

TAXATION

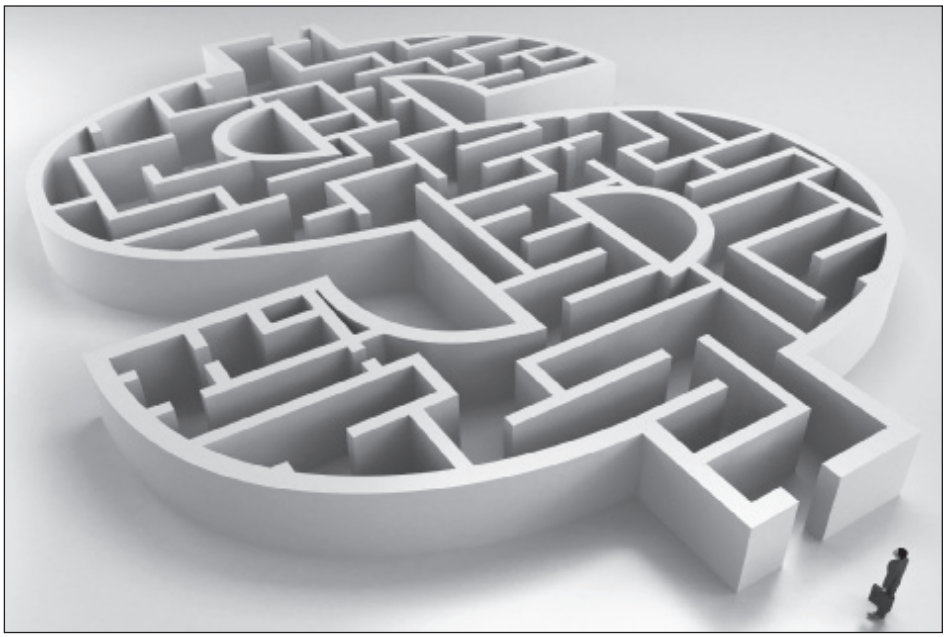
Impact of Federal Estate and Gift Tax Issues on NJ Estate Tax

By John M. Loalbo

Even though only the wealthiest estates pay the federal estate tax—i.e., starting in 2016, estates that exceed the $5.45 million per person (or, in the case of a married couple who makes a federal portability election, $10.9 million)—issues surrounding federal estate and gift taxes directly impact the New Jersey estate tax. Two of these issues are highlighted in this article: (1) the impact of making federal lifetime taxable gifts on the New Jersey estate tax; and (2) the uncertainty surrounding the availability of the New Jersey "QTIP" election when a federal estate tax return is filed solely to elect portability.

Lifetime Gifting and the NJ Estate Tax

Before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, 115 Stat. 38, New Jersey's estate tax was tied to the federal estate tax because New Jersey imposed an estate tax equal to the federal state death tax credit. EGTRRA replaced the federal state death tax credit with the federal state death tax deduction. Left without a New Jersey estate tax, New Jersey decided to "decouple" from the federal estate tax and enact its own estate tax by freezing its estate tax at the levels that existed in 2001. Accordingly, New Jersey collects a New Jersey estate tax equal to the allowable federal state death tax credit available on a 2001 Form 706 Federal Estate Tax return and requires individuals with a gross estate plus lifetime taxable gifts in excess of $675,000 to file a New Jersey estate tax return.



There is a common misconception that reducing an estate to $675,000 or below by gifting will completely eliminate the New Jersey estate tax. This is not the case.

The American Taxpayer Relief Act of 2012 made permanent a $5 million exemption amount, indexed for inflation, for federal estate, gift and generation-skipping transfer tax purposes. In contrast, the New Jersey estate tax exemption amount remains at $675,000, not indexed for inflation, and New Jersey does not impose a gift tax on lifetime gifts nor a generation-skipping transfer tax.

In this climate, New Jersey estate planners traditionally utilize gifting programs for New Jersey clients, designed to take advantage of New Jersey's tax-free treatment of lifetime gifts and the higher federal $5.45 million (in 2016) exemption amount in order to reduce the New Jersey estate tax owed at death. Although these types of gifting programs are useful in reducing New Jersey estate tax, there is a common misconception that reducing an estate to $675,000 or below by gifting will completely eliminate the New Jersey estate tax. This is not the case. In order to avoid New Jersey estate tax entirely, lifetime taxable gifts must reduce a net taxable estate (i.e., the gross estate minus allowable deductions) to $100,000 or less.

New Jersey estate tax can be reported two ways—the simplified method or the 2001 Form 706 method. The simplified method derives the estate's net estate from the estate's inheritance tax return with certain adjustments that require an estate to include gifts made within three years of death. It can only be used if it produces a tax liability similar to

Loalbo is a partner in the Trusts & Estates and Probate Litigation Practices of Riker Danzig in Morristown. *He gratefully acknowledges the assistance of counsel Stephen J. Pagano and associate Lauren N. Spitser in preparing the article.*

the Form 706 method. When gifts are involved, the Form 706 method will result in a different tax liability than the simplified method, and, therefore, in such cases, the Form 706 method should be used.

Under the Form 706 method, the allowable state death tax credit (and resulting New Jersey estate tax) is equal to the lesser of: (1) the tentative federal estate tax calculated under Table A of the 2001 Form 706 (applying the allowable federal unified credit); or (2) the state death tax credit calculated under Table B of the 2001 Form 706. In 2001, the federal unified credit was $675,000, and, therefore a net taxable estate of $675,000 without any lifetime taxable gifts produced a $0 federal estate tax. However, once lifetime taxable gifts are added in as required by the 2001 Form 706, a federal estate tax may be due, and, as a result, a taxpayer must use the lesser of the tentative federal estate tax or state death tax credit to determine the New Jersey estate tax.

When gift planning results in a net taxable estate between $100,000 and $727,174, the size of the gift will determine whether the New Jersey estate tax will equal the tentative federal estate tax under Table A or the federal state death tax credit under Table B. Gifts that reduce the taxable estate to $727,175 or above will have no impact.

For example, a net taxable estate of $600,000 plus lifetime taxable gifts of $100,000 generates a New Jersey estate tax of $9,250 (the amount of the federal estate tax calculated under Table A, which is less than the state death credit under Table B of $14,000). Yet, a net taxable estate of $600,000 plus lifetime taxable gifts of $200,000 generates a New Jersey estate tax of $14,000 (the amount of the state death credit under Table B, which is less than the federal estate tax calculated under Table A of $47,250).

In sum, a New Jersey resident may minimize the New Jersey estate tax owed at his or her death by making lifetime taxable gifts but, depending on the circumstances, New Jersey estate tax may not be eliminated in its entirety, even where the net taxable estate is reduced to under $675,000.

Portability and the Availability of the NJ QTIP Election

In order to qualify for the unlimited marital deduction and defer New Jersey estate tax until the surviving spouse's death, property passing to a surviving spouse in trust must meet certain requirements and a QTIP (Qualified Terminable Interest Property) election must be made on a New Jersey estate tax return.

Generally, under New Jersey law, an estate is bound by its choice regarding the federal QTIP election (or nonelection), i.e., you cannot make inconsistent QTIP elections for federal and New Jersey purposes. However, it is unclear whether filing a federal estate tax return solely to elect portability (portability allows a surviving spouse to use the deceased spouse's remaining federal exemption) and thus making no federal QTIP election, precludes an estate from making a separate QTIP election for New Jersey estate tax purposes. When determining how to proceed, there are two options to consider.

• *Option 1:* File a federal return, elect portability and make a federal QTIP election, even though there are no federal estate tax implications.

In Rev. Proc. 2001-38, the IRS announced circumstances in which they "will disregard [a QTIP] election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The federal QTIP election will always be unnecessary to reduce federal estate tax liability on an federal estate tax return for an estate not subject to federal estate tax filed solely to elect portability. The preamble to the final portability regulations enacted on June 12 states that the Treasury Department and IRS are planning on issuing future guidance to clarify whether a QTIP election may be disregarded if an executor has also elected portability.

In other words, there is currently no clear guidance as to whether a QTIP election which is disregarded pursuant to Rev. Proc. 2001-38 by the IRS, but nonetheless would save state estate taxes, is valid for New Jersey purposes. Even if the QTIP election is treated as null and void for federal estate tax purposes, will it also be treated as null and void for New Jersey purposes? Again, there is no clear answer to this question. New Jersey could determine that, because the Federal QTIP election was actually made (although disregarded for federal purposes), that it would be valid, but to date, there is no official guidance on this issue.

The risk here is that the IRS may argue that the QTIP election was intentionally made and will not disregard the QTIP election for Federal purposes, and will seek to tax the property subject to the election at the surviving spouse's death, even if such property otherwise would have been sheltered from the Federal estate tax.

• *Option 2:* File a federal return that just elects portability, and make a separate New Jersey QTIP election.

Generally, if an estate files a federal estate tax return, the estate is bound by its choice regarding the federal QTIP election (or nonelection) and is precluded from making a separate QTIP election for New Jersey estate tax purposes. If no federal estate tax return is filed, the executor can make a separate state QTIP election. However, at least one state has taken the position that if a federal estate tax return is filed, even if only to elect portability, the federal QTIP election or nonelection will be binding for state estate tax purposes (the State of New York took this position in NY Tech. Mem. TSB-M-11(9)M).

It may be possible to take the position that, because an estate is not required to file a federal return electing portability, the estate should not be bound by its nonelection on a federal return for New Jersey estate tax purposes, although this position appears contrary to current Division of Taxation policy. Interestingly, New Jersey has allowed civil union partners to make a separate New Jersey QTIP election for New Jersey purposes, even though they were expressly precluded from doing so for federal purposes. In addition, in *Estate of Stevenson v. Director, Division of Taxation*, 23 N.J. Tax 583 (2008), the court held the New Jersey estate tax is a fiction whereby circumstances should be viewed as they would have been in 2001, meaning that there is an argument that a QTIP election would be permitted for estates over $675,000 because the exemption amounts are aligned.

The risk here is that filing a federal return to elect portability will render the New Jersey QTIP election unavailable, which will cause an immediate estate tax consequence on the first death.

Which Option?

Although there is no clear guidance, it appears that Option 1 may be the safest approach. Practitioners have reported receiving closing letters from the State of New Jersey when making a federal QTIP election on a return filed solely to elect portability, and then making a corresponding election on a New Jersey return. Clients must be advised of the real risks in connection with both approaches, and that neither approach may work as intended. ■