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## FINANCIAL PLANNING

# Source of Estate Tax Payment Is Now an Issue

Wills must be properly drafted to account for the new deduction for state death taxes

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**W**ith New Jersey decoupling its estate tax as of 2002 from the state death tax credit provisions under the Internal Revenue Code of 1986, as amended, there is a much greater possibility for the estate of a decedent who was married at his death to owe estate tax. That change, along with the phasing out of the credit for state death taxes and its replacement beginning in 2005 with a new federal estate tax deduction for state death taxes, requires estate planners to now, more than ever, review the tax payment clause in wills they draft for their clients to make sure that taxes are paid from the proper source.

One component of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was the phase-out of the federal estate tax credit for state death taxes over a three-year period beginning in 2002. Section 2011(a)

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of the Code provided that the estate tax owed to the federal government will be credited with the amount of estate or inheritance taxes actually paid to any state, up to certain limits set forth in Code Section 2011(b)(1). EGTRRA added Code Section 2011(b)(2), which phased out the state death tax credit by providing that 75 percent of the maximum credit set forth in Code Section 2011(b)(1) will be permitted in 2002, 50 percent of the credit will be permitted in 2003, 25 percent of the credit in 2004, and finally, no credit will be allowed in 2005 and thereafter.

Effective for estates of decedents dying after Dec. 31, 2004, Code Section 2058 provides that the value of a decedent's taxable estate shall be reduced by any estate, inheritance, legacy or succession taxes actually paid to any state in respect of any property included in the decedent's gross estate. Rather than a tax credit, the payment of state death taxes is now a federal estate tax deduction.

New Jersey's estate tax was considered a "sponge" tax, which meant that the New Jersey estate tax was equal to (or soaked up) the maximum state death tax credit permitted under Code Section

2011(b). As of Jan. 1, 2005, there would have been no New Jersey tax since under EGTRRA the state death tax credit (and along with it the "sponge" tax) would then be fully phased out. In response to EGTRRA, New Jersey, along with many other states, changed its estate tax law so that its estate tax (and the revenue it generated) would not disappear with the elimination of the federal estate tax credit for state death taxes. Basically, the New Jersey estate tax was effectively "decoupled" from the state death tax credit applicable under the Code. Instead, the new law in New Jersey, effective as of Jan. 1, 2002, provides that the New Jersey estate tax is equal to what the federal state death tax credit would have been had the decedent died on Dec. 31, 2001, which requires a calculation of what the federal estate tax would have been with respect to a decedent who died on that date.

The applicable exclusion amount on Dec. 31, 2001 was equal to \$675,000. In 2005, it is equal to \$1.5 million. Under the new law, a New Jersey estate tax will be imposed if assets in excess of \$675,000 pass to someone other than a spouse, even

though the federal estate tax law permits assets up to \$1.5 million to be transferred to someone other than a spouse on a tax-free basis. This creates a situation where, to take full advantage of the applicable exclusion and maximize federal estate tax savings, a New Jersey tax will be imposed upon the death of the first spouse to die.

For example, if a decedent dies in 2005 with a \$2 million estate, \$1.5 million of which is used to fund a trust for the surviving spouse and his children using the deceased spouse's applicable exclusion (typically referred to as a "Bypass Trust" because it is designed to bypass estate taxation in both spouses' estates), no federal estate tax liability would be incurred (assuming no lifetime use of the applicable exclusion). However, since the taxable estate for New Jersey estate tax purposes exceeds \$675,000, a New Jersey estate tax would be due even though there was no federal estate tax. The New Jersey estate tax due on a \$1.5 million estate passing to nonspousal beneficiaries is equal to \$64,400, due nine months after the death of the decedent.

In 2006, when the applicable exclusion increases to \$2 million, the New Jersey estate tax would be \$99,600 if the applicable exclusion were to be fully utilized, and when the applicable exclusion increases to \$3.5 million in 2009, the New Jersey estate tax would be \$229,200 if the applicable exclusion were to be fully utilized.

Prior to 2005, assuming decedent's will in the above example provides that the Bypass Trust will first be funded with the greatest amount of assets that can pass to it without resulting in the payment of a federal estate tax (\$1.5 million), and the balance of the assets (\$500,000) will pass to the decedent's surviving spouse as the residuary beneficiary (thus qualifying for the marital deduction), the proper source for payment of the New Jersey tax due (\$64,400) was the Bypass Trust. If the estate was required to pay the New Jersey estate tax out of the residue in this example (which is the marital portion and which would otherwise qualify for the unlimited marital deduction), the

marital deduction would not be available as to the portion of the residue used to pay the New Jersey estate tax. As a result, a federal estate tax and additional New Jersey estate taxes would be due.

The use of assets intended to qualify for the marital deduction for the payment of taxes will prevent those assets from qualifying for the marital deduction because they are not being paid to or applied for the exclusive benefit of the surviving spouse. In such a case, additional assets in excess of \$1.5 million (the amount funding the Bypass Trust) would actually be deemed to pass to a nonspousal beneficiary (the state of New Jersey), which would result in federal estate tax and additional New Jersey estate tax. If marital deduction assets are used to pay estate taxes, a circular tax calculation would be required to calculate the additional tax due — i.e., the payment of taxes from the marital part would reduce the marital deduction, which consequently increases the estate tax. The payment of additional estate tax from the marital portion further reduces the marital deduction, which then increases the estate tax, and so on. There could be significant additional taxes due as a result, which is the reason why trusts and estates practitioners understand that taxes should never be paid from the portion of a decedent's will that is intended to qualify for the marital deduction.

Since the New Jersey tax could not be paid from the marital residue, it had to be paid out of the Bypass Trust. Therefore, the ultimate amount funding the Bypass Trust was less, thereby reducing the tax savings associated with the use of the Bypass Trust. In our example, the Bypass Trust would be funded with \$1,435,600; \$1.5 million less \$64,400 in New Jersey tax, rather than 1.5 million. As the applicable exclusion amount increases over the next few years, and the potential New Jersey estate tax liability increases along with it, the continued use of Bypass Trusts as the source for payment of taxes would further reduce the assets that would be sheltered from federal estate tax.

New Code Section 2058 addresses this issue in a favorable manner. Because the payment of state estate taxes is now a federal estate tax deduction, state death taxes due and owing can now be paid from the residue of the decedent's estate without jeopardizing the marital deduction. To do so, however, the tax payment clause in the decedent's will must permit the executor to pay the estate tax from the proper source. In the above example, \$1.5 million will fund the Bypass Trust, and the remaining \$500,000 will pass to the residue of the decedent's estate. Out of the remaining \$500,000, \$64,400 can be used to pay the New Jersey estate tax and qualify for the Code Section 2058 deduction, and the balance, \$435,600, will pass to the surviving spouse and qualify for the marital deduction. The result is that the Bypass Trust will remain fully funded at \$1.5 million and will not be reduced.

The tax payment clause in the decedent's will controls where the executor looks for authority to pay estate taxes. If, in the above example, decedent's will contained a tax payment clause providing that all taxes due at the death of the first spouse to die must be paid from the Bypass Trust, the executor must take \$64,400 from the Bypass Trust to pay the estate tax due. Consequently, the Bypass Trust will be underfunded, despite the fact that the payment of state death taxes is now an allowable federal estate tax deduction. For wills that have been drafted in the manner as set forth above (first fund the Bypass Trust), it is unlikely that the tax payment clause would allow the executor to pay taxes from the residue. That is because, prior to Jan. 1, 2005, the payment of taxes from the residue would have resulted in additional estate tax (pursuant to the circular computation as discussed above).

Wills designed to maximize the applicable exclusion and the marital deduction can be structured in several different ways. Although the structure described above whereby the Bypass Trust is funded first would likely not maximize estate tax savings as a result of the new Code Section 2058, wills

that contain the most popular alternative structure — first fund the marital portion with the smallest amount required to reduce the federal estate tax to zero with the residue passing to the Bypass Trust — are more likely to achieve the maximum estate tax savings even with the new Section 2058 deduction.

Under this alternative structure, the executor is first required to pay to the spouse the smallest amount necessary to reduce the estate tax to zero. Without the Section 2058 deduction, \$500,000 would need to go to the spouse to keep the taxable estate at \$1.5 million. However, since the

\$64,400 of New Jersey estate tax can now be deducted under Section 2058, the smallest amount needed to reduce the federal estate tax to zero is reduced from \$500,000 to \$435,600. This leaves the full \$1.5 million to pass into the Bypass Trust sheltered from federal estate tax in both spouses' estates.

Prior to 2002, the New Jersey estate tax was not an issue that New Jersey estate planners needed to consider for their clients. However, with EGTRRA's enactment, and the decoupling of New Jersey's estate tax, the New Jersey estate tax has

become an important topic for New Jersey estate planners and their clients. Code Section 2058 and the new federal estate tax deduction for state death taxes is another reason for New Jersey estate planners to carefully review all of the implications of the New Jersey estate tax, including the source from which the tax is to be paid. All estate planning practitioners should review their wills and make any necessary changes to ensure that all death taxes can be paid from the proper source to maximize the tax savings of their clients. ■