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DEATH TAX PLANNING IN NEW JERSEY

As of this writing, we are in a period of uncertainty regarding the future of the federal estate tax. Although the House of Representatives has repeatedly voted to end the tax, the Senate has repeatedly voted to continue the tax. Many individuals have their own ideas about what will happen, but the truth is that nobody knows. If tax planning is an issue, flexibility is the key to a successful tax reduction strategy. Even if both houses of Congress and the President agree to end the federal tax, planning to reduce New Jersey Estate and Inheritance taxes must be considered.

The **Federal Estate Tax** is a tax on the right to transfer property at death and is imposed on a decedent's taxable estate, i.e. the value of all interests in property the decedent owned at the time of his death. The taxable estate includes, but is not limited to, the face value of life insurance policies, retained life estates, retirement funds, real estate, cash equivalents, personal property, business interests *etc.* The IRS has very technical rules for determining what property is taxable. If the value of the taxable estate falls below the applicable exclusion amount, no federal estate tax is due. The exclusion amount in 2008 is $2 million. In 2009 the amount will be $3.5 million. In the 2010 there is no tax, but in 2011 the exclusion amount is scheduled to be $1 million with a tax rate of 55%.

The **State of New Jersey imposes an estate tax** if the value of a decedent's taxable estate exceeds $675,000.00. This is not scheduled to change; there is no plan for the elimination of New Jersey estate taxes. Although your estate may pay no Federal estate tax, your estate may have a New Jersey estate liability. The need for estate tax planning is not diminished, in fact, if reduction of estate taxes is a concern, planning is even more important. Assuming the taxable estate value is $700,000.00 the estate will pay $18,000.00 to the State of New Jersey. If the estate is valued at $1,600,000.00, the estate will pay the State of New Jersey about $70,800.00. A $3.6m estate will pay $238,800.00

New Jersey also imposes an **Inheritance Tax** on transfers to extended family and unrelated persons. The tax rate ranges from 11% to 16% depending on the amount of transfer and the relationship between the decedent and the recipient.

Federal and state law permits techniques designed to reduce or eliminate estate and inheritance taxes. The tools available include Testamentary Trusts created in your Last Will and Testament, Properly Drafted Business Agreements, *Inter Vivos* Life Insurance Trusts and Charitable Trusts, correct life insurance and retirement account beneficiary designations, gifts during life and other legal techniques designed to reduce or eliminate the tax bite.

Don't make the mistake of ignoring death taxes. We still have substantial federal and New Jersey taxes. Proper planning may help you pass more of your property on to your heirs.

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WILLS AND TESTAMENTARY TRUSTS PROTECT YOUR FAMILY

The primary purpose of Wills and Trusts created in your Will, but not funded until after your death, is protecting your beneficiaries from themselves and creditors. Trusts created in your Will are called **Testamentary Trusts**.

A **By-Pass Trust** is a great way to reduce estate taxes but it can also provide a surviving spouse with income while preserving trust principal for children of the current or a prior marriage. The By-Pass Trust may also be used to assure that wealth is responsibly used for the benefit of minor and adult children. The family, spendthrift, asset protection and special needs provisions described in the following paragraphs may be included in your by-pass trust.

With a testamentary **Family Trust** you may provide income to your adult child while minimizing the risk that the funds will pass to the child's spouse upon the child's death or divorce. Upon the child's death, the trustee may continue the trust for the sole benefit of the grandchildren. The Family Trust may include spendthrift and asset protection provisions described in the following paragraphs.

An **Asset Protection Trust** is a type of trust that is designed to protect the trust funds from an adult child's creditors. The **Trustee** has the discretion to distribute income and principal to the beneficiary for specific purposes. As long as there is no judgment or divorce, the trustee can freely distribute assets to the beneficiary. As soon as a legal problem crops up, the trustee may stop distributions and the creditor or spouse has no right to compel distributions.

Similar to the Asset Protection Trust, a **Spendthrift Trust** is appropriate when a beneficiary is unable to manage money or suffers from substance abuse. You want to assure that the beneficiary will have enough money to live, but you also want the money to last for years rather than months. As with the Asset Protection Trust, the trustee has the discretion to distribute income and principal to the beneficiary as needed and only for prudent expenses.

A **Special Needs or Supplemental Benefits Trust** minimizes the risk that a spouse, child, parent or sibling who is under disability may lose eligibility for public benefits such as Supplemental Security Income (SSI) and **Medicaid**. When the disabled beneficiary dies the trustee may distribute the balance of the funds held in trust to or for the benefit of another person who is called the remainder beneficiary.

Whether or not and what type of trust may be appropriate for you depends upon your specific case.

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CONSIDER AN IRREVOCABLE LIFE INSURANCE TRUST (ILIT) TO REDUCE ESTATE TAXES

Insurance on your life will be included in your taxable estate if either (1) Your estate is the beneficiary of the insurance proceeds, or (2) You possessed certain "incidents of ownership" in the policy within three years of your death.

Incidents of ownership that will cause the proceeds to be taxed in your estate include the rights to: change beneficiaries, assign the policy, pledge the policy as security for a loan, borrow against the policy's cash surrender value, and surrender or cancel the policy. A life insurance trust is an effective way to keep life insurance proceeds from being taxed in your estate.

The irrevocable life insurance trust owns the policy and receives the proceeds after your death. A properly drafted life insurance trust keeps the insurance proceeds from being taxed in your estate as well as in the estate of your surviving spouse. It also protects the trust beneficiaries against their creditors, including an ex-spouse in the event of divorce. Here's how the irrevocable life insurance trust works.

You create an irrevocable life insurance trust to be the owner and beneficiary of one or more life insurance policies on your life. You may either assign an existing policy to the trust (in which case you must live for three years) or the trustee may purchase a new policy on your life. You contribute cash to the trust and the trustee pays the premium. If the trust is properly drafted, the contributions you make to the trust for premium payments will qualify for the annual gift tax exclusion ($12,000.00 in 2007), so you won't have to pay gift tax on the contributions.

The life insurance trust typically provides that, during your lifetime, principal and income, in the trustee's discretion, may be paid or applied to or for the benefit of your spouse and descendants. This allows indirect access to the cash surrender value of the life insurance policies owned by the trust, and permits the trust to be terminated if desired despite its being irrevocable. On your death, the trust continues for the benefit of your spouse during his or her lifetime. Your spouse is given certain beneficial interests in the trust, such as the right to income, limited invasion rights, and eligibility to receive principal. On the death of your spouse, the trust assets are paid outright to, or held in further trust for the benefit of, your descendants.

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Forgetting Your Beneficiary Forms May Defeat Your Estate Plan

The failure to correctly complete the forms that designate the beneficiaries of your life insurance policies and retirement plan accounts may undermine your entire estate plan. Here are a few tips on doing it right.

Never name your estate as the beneficiary or permit your estate to become the beneficiary by default. Permitting your estate to be the beneficiary deprives the ultimate beneficiary of significant income-tax benefits and strips the assets of their protection against the claims of creditors.

Never name a friend or family member as beneficiary and make her promise to use the money for your child. Three big problems immediately come to mind. First, the friend has no legal obligation to use the money for your child. Second, if your friend gets a judgment against her, her creditors may take the money. Third, if your friend dies or gets divorced, her husband, not your child, may get the money.

Never name a minor child as beneficiary. Most couples name their minor child as contingent beneficiary; this is not a good idea. First, someone will have to ask the court to appoint and qualify him as guardian of the minor's property. Second, the child will get full control over the money on his eighteenth birthday.

Never name an irresponsible adult as beneficiary. The beneficiary will waste the funds in no time. Never name a disabled adult as beneficiary; receiving the money may result in a loss of public benefits such as SSI and Medicaid.

How do you manage these issues? If all beneficiaries are responsible adults under no disability you may name them as the designated beneficiaries, but naming an asset-protection trust as beneficiary is a better idea.

If a beneficiary is under age 18, disabled or irresponsible consider creating a trust in your Last Will and Testament. You may name the trustee who is legally responsible for managing and spending the funds in the trust for the benefit of the beneficiaries. The trust funds will be protected from the claims of the trustee's and beneficiaries' creditors. You may control the purposes for which and the age or ages at which the funds are distributed to your beneficiary. A well-drafted trust will preserve the beneficiary's eligibility for public assistance. Designating a trust created in your Last Will as beneficiary is not the same as naming your estate as beneficiary; therefore the asset-protection and income-tax benefits are preserved.

If you are married with children, ordinarily you should name your spouse as primary beneficiary and your testamentary trust as contingent beneficiary.

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Planned Giving Techniques

Supporting your house of worship or favorite charity (exempt entity) through gifts is a great way to reduce income and death taxes. Gifts may include cash and cash equivalents, securities, insurance policies, retirement plan assets, personal property and real property. Subject to rather liberal restrictions, you may deduct annual donations of money and short-term capital gain property to charity, up to 50% of adjusted gross income (AGI). Long-term capital-gain property is limited to 30% of AGI. In subsequent years, you may deduct the value of gifts in excess of these limitations.

There is no limit on the deductibility of charitable gifts for gift and estate tax purposes; this means that remembering an exempt entity in your Will may reduce the amount of death tax your estate will pay.

You may immediately deduct the value of outright gifts, and the exempt entity may immediately use the funds, yet techniques are available to further increase the benefit to you and your family, as well as the exempt entity. Philanthropic tools may involve establishing a trust, designating the exempt organization as beneficiary of your retirement plan or assigning a life-insurance policy.

By assigning a life-insurance policy to the exempt entity, you may leverage your annual, deductible gifts while giving the exempt entity the use of cash value and the right to the proceeds upon your death. Every year you donate to the exempt entity the amount of the annual premium, for which you receive a deduction. The exempt entity is responsible for forwarding the premium to the insurance company.

Gifts of retirement plan assets, e.g. 401(k) or Traditional IRA, offer you and your family significant tax benefits.

The Charitable Remainder Trust (CRT) entitles you, or the beneficiaries you name, to receive a stream of income for a term of years or life. When the trust terminates the exempt entity receives the remaining principal. Private Foundations and Supporting Organizations offer you opportunities to support tax-exempt entities, reduce taxes, nurture civic responsibility in your family and build a legacy.

You may even start a business and donate all or a portion of the shares of stock to the exempt entity.

Giving techniques come in all shapes and sizes; the vehicle that is right for you depends upon your goals and situation.

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Use A Durable Power of Attorney To Avoid Problems

Although it does happen, it is a rare event when I suggest that a client not sign a **Durable Power of Attorney (DPOA)**, a document that creates a legal, enforceable relationship between the person who signs it (known as the "principal") and the person who acts for the principal (known as the "agent," "attorney-in-fact," or "personal representative"). It is important to note that a DPOA is freely revocable at any time before you become incapacitated. After that, a judge who finds cause may revoke the authority granted in the DPOA.

When you, as principal, sign a Durable Power of Attorney you authorize your agent to manage your finances and property in your best interests. The agent owes a **fiduciary duty** to you and your heirs to act prudently under all the circumstances for you. An agent who engages in self-dealing and who raises his own interests above your interests or the interests of your other family members may be subject to civil and criminal penalties.

A well-drafted DPOA tends to avoid the need for a person to ask a court to declare you incompetent and for an order of **Guardianship**. Such a proceeding wastes time and money that can be better used for your benefit.

There are a variety of cases in which a DPOA may be necessary. Consider these examples. (1) If you and your spouse own any real property together you probably own it as tenants by the entirety. If so, neither of you may sell, mortgage or otherwise affect legal title without the consent of the other. If one of you becomes incapacitated and the other needs to sell the property or refinance, the healthy spouse will have to seek an order of guardianship from the court before conducting the transaction. (2) Some individuals create a joint bank account in place of signing a DPOA; this can cause more problems than it avoids.

In many situations lifetime gifts represent a valuable asset-protection and estate-planning technique. The existence of a valid, well-drafted DPOA that includes an appropriate authority to make gifts may facilitate the implementation of the plan. The law in New Jersey is clear: an agent under a DPOA that does not specifically grant the authority to make gifts legally may not make gifts.

The most important qualifications for an agent are trustworthiness and an understanding of the agent's fiduciary duty. Too often the agent misuses his "power" to the detriment of the principal and the principal's family. The agent's inability or refusal to act responsibly may result in acrimony among the family members along with prolonged, emotional and expensive court proceedings. Competent professional advice can go a long way to avoiding very serious problems.

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What is a Living Will?

In addition to Wills, Trusts and Powers of Attorney, every estate-planning client should consider signing an Advance Directive for Health Care.

An advance directive for health care (commonly called a "living will") is a legal document in which an individual (known as the "declarant") expresses his wishes regarding medical treatment and the use of life-sustaining procedures. The declarant may appoint a person to serve as health-care agent to make decisions if a physician determines that the declarant lacks the capacity to make health-care decisions.

The declarant may revoke the wishes expressed and the authority granted in the document at any time prior to incapacity. The document is not effective until the attending physician issues a determination, in writing, that the patient lacks capacity to make a particular health care decision. "Decision making capacity" means a patient's ability to understand and appreciate the nature and consequences of health care decisions, including the benefits and risks of each, and alternatives to any proposed health care, and to reach an informed decision. A patient's decision making capacity is evaluated relative to the demands of a particular health care decision.

The advance directive may provide that life-sustaining treatment, which is the use of any medical device or procedure, artificially provided fluids and nutrition, drugs, surgery or therapy that uses mechanical or other artificial means to sustain, restore or supplant a vital bodily function, and thereby increase the expected life span of a patient, may be withheld or withdrawn from a patient: (a) When the life-sustaining treatment is experimental and not a proven therapy, or is likely to be ineffective or futile in prolonging life, or is likely to merely prolong an imminent dying process; (b) When the patient is permanently unconscious, as determined by the attending physician and confirmed by a second qualified physician; (c) When the patient is in a terminal condition, as determined by the attending physician and confirmed by a second qualified physician; or (d) When the patient has a serious irreversible illness or condition, and the likely risks and burdens associated with the medical intervention to be withheld or withdrawn may reasonably be judged to outweigh the likely benefits to the patient from such intervention, or imposition of the medical intervention on an unwilling patient would be inhumane.

Whether or not an Advance Directive is appropriate for you and the terms that should be included in the document are fact-sensitive decisions. Feel free to call for more information.

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