

# Don't Forget About New Jersey's Inheritance Tax

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October 19, 2018 | by Matthew Rheingold

The recent Appellate Division case of *Estate of Mary Van Riper v. Director, Division of Taxation*, (Oct. 3, 2018, N.J. Sup. Ct. App. Div., Docket No. A-3024-16T4) illustrates the perils of hasty deathbed planning without consideration of potential inheritance tax issues. New Jersey is one of six states that imposes an inheritance tax on transfers of property at death based upon the recipient. In New Jersey, recipients are categorized into different “classes” and each class is taxed at a different rate. While no tax is imposed on Class A beneficiaries (generally, spouses and lineal family members) or Class E beneficiaries (charities), New Jersey does tax transfers to any other beneficiary. Transfers to Class C beneficiaries (siblings and sons/daughters-in-law) are taxed after the first \$25,000 at a rate of 11%-16% depending on the amount of the transfer. Transfers to Class D beneficiaries (all others) are taxed at a rate of 15% on the first \$700,000 and 16% on the amount in excess of \$700,000.

Like many married couples, Edward and Mary Van Riper owned their home as a tenancy by the entirety (a “TBE”), which is a special form of ownership only available to married couples. Under a TBE, each spouse owns 100% of the property. At the first spouse’s death, the property “passes” to the surviving spouse, not by Will, operation of law or right of survivorship, but by reason of original title. As the *Van Riper* court notes, if you think of a married couple as a singular unit, these concepts become a little easier to wrap your head around. One of the major benefits of a TBE in New Jersey and many other states is that a creditor of one spouse cannot “take the house” if the other spouse still owns it.

Edward and Mary established a joint irrevocable trust and transferred their marital home from a TBE to the trust on December 5, 2007. The terms of the trust provided that Edward and Mary, or the survivor of them, had the right to live in the house for the rest of their lives. Upon the surviving spouse’s death, the trustee was directed to distribute the remaining trust assets to their niece. Edward passed away 19 days after the transfer. Mary remained in the house until her death almost six years later to the day.

Although the house passed to Mary's niece as a result of her death, the NJ Inheritance Tax Return filed by Mary's estate took the position that no tax was due. Upon audit, the Division of Taxation disagreed and assessed an inheritance tax on 100% of the property's fair market value. The estate paid the tax and sued for a refund in NJ Tax Court.

At the Tax Court level, the estate moved for summary judgment with alternative arguments. The estate argued that no inheritance tax was due on the transfer of the house because it occurred when the house was transferred to the trust more than three years before Mary's death.<sup>[1]</sup> The estate alternatively argued that inheritance tax should only be imposed on one-half of the house representing Mary's share. In denying the estate's motion in its entirety and granting the Division's cross-motion to uphold the assessment, the Tax Court reasoned that Edward and Mary had retained a life estate in the use and beneficial enjoyment of the house and as such, the actual "transfer" to their niece did not occur until Mary's death. However, the Tax Court gave a very brief and cryptic explanation of why 100% of house was taxed at Mary's death rather than just 50% as the estate argued.

On appeal, the estate abandoned its three-year lookback argument, but posited that the Tax Court erred in determining 100% of the property was subject to inheritance tax at Mary's death. The Appellate Division upheld the Tax Court's decision focusing primarily on the fact that the property was titled as a TBE before it was transferred to the trust. The Court reasoned that each of Edward and Mary had an undivided interest in the property both before and after it was transferred to the trust and that Mary's 100% interest in the property was not altered when Edward died. Moreover, the intent of the trust was for Edward and Mary to live in the house for the rest of their lives and only at the surviving spouse's death was their niece to inherit the property. Thus, the intent was for the niece's possession of the property to take effect upon the death of *both* Edward and Mary. The Court went on to hold that the Division "properly included the value of the property in Mary's Estate for inheritance transfer tax purposes" because Mary had an undivided interest in the entire property which she transferred to her niece at her death.

Edward and Mary tried to have their cake and eat it too. They wanted to keep their home, but avoid the NJ Inheritance Tax. In order to avoid the NJ Inheritance Tax on a transfer to a Class C or D beneficiary, the transfer must be a completed gift (i.e. no retained interest) and must be made more than three

years before death. Nevertheless, there are techniques to minimize transfer taxes (the practicality of such techniques vary depending on individual circumstances).

For example, it can be safe to assume that based upon the timing of Edward's death and the funding of the trust, it was likely known that Edward's death was imminent. At that point, the Van Ripers' estate, including the house, could have been transferred entirely into Edward's name. Under a carefully prepared Will, Edward's estate could have been left in trust for the benefit of Mary during her life. Under the terms of the trust, Mary would be entitled to receive all income from the trust and distributions of principal for her health, maintenance and support in her accustomed manner of living. Distributions of principal exceeding those needs could be made by a non-interested trustee. Upon Mary's death, the remainder of the trust would pass to her niece.

Two questions arise from this plan:

- Is the transfer of Edward's estate to the trust subject to NJ Inheritance Tax?
- How much tax is owed?

Under this scenario, the transfer at Edward's death is subject to NJ Inheritance Tax. Although Mary is a Class A beneficiary, it is possible that a portion of the trust will pass to Mary's niece, a Class C beneficiary. To calculate the total tax owed, one must determine how much of the trust will pass to Mary's niece upon Mary death. Unfortunately, it is impossible to do this beforehand. There is no way to forecast what distributions of principal will be made to Mary during her life. Thus, when Edward passes away, there are two options – 1) post a bond and when Mary dies, the inheritance tax is assessed on the remainder of the trust actually passing to her niece; or 2) pay a "compromise tax."

The idea behind the compromise tax is that NJ wants its share of the tax when Edward dies and does not want to wait until Mary's death. Therefore, the state is willing to look at the underlying circumstances of the beneficiaries and "negotiate" with Edward's estate as to how much of the initial principal each thinks will eventually pass to the niece upon Mary's death. If more ultimately passes to the niece, then the estate was on the better end of the deal.

[i] If a transfer is made within three years of an individual's death, it is deemed as if the transfer was made in anticipation of death and it is subject to inheritance tax.