planning matters

PRACTICAL INSIGHTS INTO ESTATE PLANNING & WEALTH PRESERVATION

INSIDE FOR WINTER 2017

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basis and its impact on lifetime gifts

by David G. Hardin, Esq.

A previous article appearing in Planning Matters discussed the use of lifetime gifts to reduce New Jersey estate taxes. The article pointed out that although there can be advantages to lifetime gifts, there are situations where embarking on a lifetime gifting program in New Jersey is ill-advised. This article will address some of those circumstances where lifetime gifts will not result in a tax benefit.

The Basis Concept

The starting point for this discussion is the income tax concept of basis. Basis is relevant for determining the gain realized from the sale or other disposition of property for capital gain tax purposes. In general, the basis of property is the cost of the property to the taxpayer. There are special rules with respect to basis where property is acquired by lifetime gift and where property is acquired from a decedent.

In the case of property acquired from a decedent's estate, Section 1014 of the Internal Revenue Code provides the general rule that the basis of property in the hands of a beneficiary is the fair market value of the property at the date of the decedent's death. This concept is oftentimes referred to as "stepped-up basis" because the taxpayer receives a free step-up in basis to the value of the property at the time of the decedent's death without being subjected to the payment of a capital gain tax.

In the case of property acquired by lifetime gift, Section 1015 of the Code provides the general rule that the basis of property in the hands of the recipient of the gift is the same as the donor's basis in the property. This concept is generally referred to as "carryover basis" because the basis of property in the hands of the recipient of a gift is carried over from the donor of the gift.

Stepped-Up vs. Carryover Basis

It is critical to understanding why lifetime gifts to avoid New Jersey estate tax are not always tax efficient in the larger sense based upon the concepts of stepped-up basis and carryover basis. To illustrate the point, note the following examples:

1. Assume a New Jersey resident decedent dies in 2017 with an estate of $3-million. In this case, the total New Jersey estate tax is $82,400, and the basis of the estate property in the hands of the beneficiary is $3-million, as a result of the step-up in basis on death provided by Section 1014.

2. Assume a New Jersey resident has an estate of $3-million, of which $2-million is cash and $1-million is a house having a basis of $100,000, and before death in 2017, the decedent makes a lifetime gift of the cash, leaving an estate of $1-million consisting of the house. In this case there is no New Jersey estate tax because the estate is under the $2-million threshold, and there is an estate tax savings of $82,400. The basis of the cash gift in the hands of the recipient is $2-million, the same as in the hands of the decedent, due to the carryover basis for lifetime gifts provided by Section 1015, and the basis of the beneficiary in the house is $1-million, due to the step-up in basis on death provided by Section 1014.

3. Now, assume a New Jersey resident has an estate of $3-million, of which $2-million is a house having a basis of $100,000 and $1-million is cash, and before death in 2017, the decedent makes a lifetime gift of the house, leaving an estate of $1-million consisting of the cash. In this case there is no New Jersey estate tax because the estate is under the $2-million threshold, and there is an estate tax savings of $82,400. However, with respect to the lifetime gift of the house, the carryover basis rule applies and if the recipient of the gift of the house were to sell it, the basis in the house for capital gain purposes is $100,000, the same as the basis in the hands of the donor. The result is that a capital gain would be realized in the amount of $1.9-million, which at federal capital gain rates could be as high as 23.6% and at New Jersey capital gain tax rates could be as high as 8.97%, and the recipient of the lifetime gift of the house could be exposed to federal and New Jersey capital gain taxes upon its sale as high as $618,830!

In the last example, one would certainly prefer to pay a New Jersey estate tax of $82,400 and receive a step-up in basis at death, over the capital gain tax of $618,830 that resulted from the lifetime gift of the house. Had the house been held in the estate at the time of death, rather than been the subject of a lifetime gift, the capital gain tax could have been avoided entirely.

As Example 3 vividly demonstrates, it is important to carefully consider all of the relevant tax aspects before implementing a lifetime gifting program to reduce New Jersey estate taxes. Otherwise, the consequences could be severe.

creditor protection for inherited IRAs

by Mary Patricia Magee, Esq.

It has long been the law that retirement accounts, as defined in 11 U.S.C. § 522(b)(3)(C), are exempt from the reach of a bankruptcy trustee. In Clark v. Rameker, 134 S. Ct. 2242 (2014), the United States Supreme Court was called upon to decide whether funds contained in an inherited Individual Retirement Account ("IRA") qualify as retirement funds "within the meaning of the bankruptcy exemption." The Court held that an inherited IRA does not qualify for the bankruptcy exemption and is subject to the claims of creditors. In making its decision, the Court identified three independent characteristics that differentiate an inherited IRA from an IRA in the hands of the account owner or plan participant. For the following reasons, the Court held that the recipient of an inherited IRA may not benefit from the protection afforded to the owner or participant in a traditional retirement account.

1. The owner/beneficiary of an inherited IRA may never invest additional money in the account.
2. The beneficiary of an inherited IRA must take distributions from the account annually beginning in the year after the deceased owner's death, based upon the beneficiary's life expectancy.
3. A person who has inherited an IRA may withdraw the entire balance at any time and for any purpose without penalty.

NJ Qualifying Trusts

In contrast to the Federal law, in New Jersey it has been determined that an inherited IRA constitutes a "qualifying trust" under N.J.S.A. 25:2-1(b) and as such will be excluded from a debtor's bankruptcy estate. In Re: Andolino, 525 B.R. 588 (Bankr. D.N.J. 2015). In Andolino, the New Jersey Bankruptcy Court found that the language of the New Jersey Statutes exempts the inherited IRA from the bankrupt's estate. N.J.S.A. 25:2-1(b) provides that "any property held in a qualifying trust and any distributions from a qualifying trust, regardless of the distribution plan elected for the qualifying trust, shall be exempt from all claims of creditors and shall be excluded from the estate in bankruptcy." A "qualifying trust" refers to a trust "created or qualified and maintained pursuant to Federal law, including but not limited to § 408 of the Internal Revenue Code of 1986." The New Jersey Bankruptcy Court noted that the IRA's "status as a qualifying trust remains unchanged, notwithstanding the debtor's receipt of the IRA as a beneficiary." Andolino, supra at 591.

Covering Potential Loopholes

In today's mobile society a debtor who is protected under New Jersey law may move to another state, such as Wisconsin, which excludes the inherited IRA from protection from creditors. If there are concerns about the ability of a beneficiary's creditors to obtain control over an inherited IRA account, it is recommended to make the proceeds payable to a trust for the benefit of the beneficiary.

Reasons to Name a Trust as IRA Beneficiary

- to assure that upon death of the 2nd spouse, the account will pass to the original participant's descendants
- to mandate that a beneficiary stretches out payments and defers income tax over the beneficiary's lifetime
- to protect the beneficiary against imprudence
- to provide professional management of the funds
- to avoid estate tax on the beneficiary's death
- to plan properly for a special needs beneficiary

Qualifying Trust Requirements

Once a decision is made to make the IRA payable to a trust, the trust must meet certain highly technical requirements. A discussion of the specific requirements is beyond the scope of this article. Typically, trusts that hold IRAs will be either conduit trusts or accumulation trusts. In a conduit trust, the trustee is directed to withdraw from the IRA the minimum required distribution ("MRD"), deposit it to the trust account, and then make the payment of that MRD amount to the beneficiary of the trust. In many cases, such as the case of a trust for a surviving spouse or an otherwise competent child, the mandatory pass-through component of the conduit trust will work.

Trusts for the benefit of special needs beneficiaries or minors, however, would suffer from this kind of provision because payment to a special needs beneficiary or a minor child would often be inadvisable. In the case of a special needs beneficiary, it is important to be mindful of the need to avoid the beneficiary's disqualification from receipt of government benefits. In such cases, accumulation trusts should be used. An accumulation trust allows the trustee to take the MRDs from the IRA and hold them in the trust until such time as a distribution to the beneficiary is appropriate. Certain provisions must be included in an accumulation trust that will ensure that the life expectancy of the special needs beneficiary will be used to calculate the MRDs even though such distributions are not paid directly to the beneficiary.

The rules applicable to a trust that is intended to receive inherited IRA benefits over the life of a beneficiary are strict and complex. The significant amount of wealth contained in retirement accounts in this country coupled with the income tax burdens applicable to such accounts make careful planning in this area a necessity.

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