planning matters

PRACTICAL INSIGHTS INTO ESTATE PLANNING & WEALTH PRESERVATION

INSIDE FOR FALL 2016

Lifetime Gift Planning in NJ • Proposed Treasury Regulations Regarding Valuation Discounts

Dealing with Digital Assets During Life & After Death

"Pet Trusts" Providing for Your Pets After Death

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lifetime gift planning

IN NEW JERSEY

by David G. Hardin, Esq

New Jersey has been widely recognized as among the more onerous states in terms of transfers at death. While federal and state death tax laws have been loosened over the past many years so as to exempt more and more people from estate and inheritance taxes, New Jersey has not been among them. New Jersey's estate tax exemption stands at $675,000 per person.[1] By contrast, the federal estate tax exemption is currently $5,450,000 per person;[2] the New York estate tax exemption is currently $4,187,500 (rising to the federal exemption level in 2019); the Connecticut estate tax exemption is $2-million; and Florida has no estate tax at all.

Federal Estate Tax

The federal estate tax regimen encompasses both lifetime gifts and death-time transfers. The federal estate tax exemption is reduced by taxable gifts made during lifetime. For example, an individual making a taxable gift of $100,000 in 2016 would reduce his or her federal estate and gift tax exemption by that amount, leaving a remaining federal estate and gift tax exemption of $5,350,000. An individual making a taxable gift during lifetime does not incur a gift tax liability for federal purposes until the entire federal exemption is exhausted. In 2016, that means one would have to make taxable gifts in excess of $5,450,000 before a gift tax becomes payable. This unified estate and gift tax structure for federal purposes does not differentiate between lifetime and death-time transfers, and consequently for gifts of equal value up to the maximum federal exemption amount there is no intrinsic benefit of a lifetime gift over a death-time transfer.[3]

New Jersey Estate Tax

In contrast to the federal estate and gift tax regime, New Jersey imposes a tax only on death-time transfers. For policy reasons that are not entirely evident, New Jersey does not impose a tax on lifetime gifts.[4] This anomaly between the federal and New Jersey tax structures offers a planning opportunity in a number of situations. An example will illustrate the point. Assume that an unmarried individual has a taxable estate with a value of $2-million and that the beneficiaries are children of the individual. Given the federal exemption of $5,450,000, there is no federal estate tax liability, regardless of the identity of the individual beneficiaries. For New Jersey death tax purposes, inasmuch as the beneficiaries are children of the individual, the New Jersey inheritance tax is inapplicable, and the only tax of concern is the New Jersey estate tax. The New Jersey estate tax on a taxable estate of $2-million is $99,600.

Now, assume the same facts, and further assume that prior to death the individual had made a lifetime taxable gift of $1.5-million to children. For federal estate tax purposes, the lifetime gift of $1.5-million requires the filing of a federal gift tax return, but the return merely reports the gift and the reduction of the federal estate and gift tax exemption by $1.5-million, leaving an exemption balance of nearly $4-million to be applied to future lifetime gifts or on death. As such, there is no federal estate or gift tax liability. For New Jersey death tax purposes, the lifetime gift is not included in the New Jersey taxable estate upon death. Although the existence of the lifetime gift will affect the amount of the New Jersey estate tax payable upon death, it is not a one-to one correlation, and the tax will be significantly reduced. After the $1.5-million lifetime gift, the death tax payable on a taxable estate of $500,000 is $10,000, significantly less than the $99,600 payable on a taxable estate of $2-million in New Jersey.

In Summary

The critical concepts to grasp are:

- New Jersey does not impose a gift tax
- Lifetime gifts do not impact the New Jersey estate tax exemption available at the time of death
- Lifetime gifts can be used to significantly reduce New Jersey estate tax liability

Despite the tax advantages that can accrue from lifetime gifts, they are not always advisable, and the benefits will depend on particular circumstances. For example, an individual would not want to make lifetime gifts that leave the individual with insufficient resources to maintain his or her lifestyle and meet future expenses. Further, the potential capital gain tax consequence of a lifetime gift is an important consideration in any analysis. As is often the case, there are generally a number of factors to be considered before embarking on any gifting program. A future article will address the potential drawbacks of making lifetime gifts in New Jersey.

At the time of printing this newsletter, Governor Christie and State legislative leadership had announced an agreement to raise the gasoline tax in order to allow the Transportation Trust Fund to provide additional funding for infrastructure and road improvements and maintenance. The bill has not yet been formally approved by the legislature. As part of the agreement, the New Jersey estate tax exemption is slated to increase to $2-million in 2017 before complete repeal as of January 1, 2018. The estate tax repeal, if enacted, will eliminate the benefits of lifetime gift planning to reduce New Jersey estate tax, although the concept will still apply in more limited circumstances until that time.

1. *New Jersey has both an estate tax and an inheritance tax. The New Jersey inheritance tax does not apply to transfers to a spouse, lineal ancestors, lineal descendants, stepchildren, or sons- or daughters-in-law, or to charity. New Jersey inheritance tax applies only to collateral relatives (i.e., siblings, nieces, nephews) or unrelated parties. As such, the New Jersey inheritance tax has increasingly limited application. Estates do not pay both an inheritance tax and an estate tax. Rather, an estate pays the higher of the two, and any amounts due for New Jersey estate tax receive an offset for any New Jersey inheritance tax paid.*
2. *The federal estate tax exemption is indexed for inflation. This year's exemption of $5,450,000 is $20,000 more than the federal exemption of $5,430,000 available in 2015, which was $90,000 more than the $5,340,000 exemption in 2014. In 2017, the exemption will increase to $5,490,000.*
3. *There are, of course, benefits that accrue from a lifetime gift, the most obvious being that not only is the gift out of the donor's New Jersey taxable estate once the gift is made, but also all future appreciation on property given away during lifetime is also removed from the donor's estate for federal and New Jersey estate tax purposes.*
4. *While New Jersey does not tax lifetime transfers generally, there are circumstances where a gift made within three years of death is brought back into an estate and subject to tax. For example, gifts made within three years of death can be considered to have been made "in contemplation of death," and therefore subject to tax for transfer inheritance tax purposes.*

CAUTION AHEAD!

proposed treasury rules mean to deny or diminish lack of marketability and control discounts for transfers of interests in family controlled businesses and investment funds

by Robert S. Schwartz, Esq.

On August 4, 2016, the U.S. Department of Treasury issued proposed rules under Sections 2701 and 2704 of the Internal Revenue Code of 1986, as amended (the "Code"). The proposed rules reverse, in part, and add to existing regulations adopted on January 28, 1992. Sections 2701 and 2704, and companion Code provisions 2702 and 2703, fall under the umbrella of Chapter 14—Special Valuation Rules. They became law as a result of the Omnibus Budget Reconciliation Act of 1990, generally effective October 8, 1990 (the "1990 Act").

Current Law

Estate planners, tax attorneys and others have long relied upon the fact that the 2701 and 2704 regulations constituted settled law. Indeed, numerous United States Tax Court and other Federal court decisions since 1992 focused mainly on factual issues, such that the main thrust of the case law has been interpreting Chapter 14 and accompanying regulations against the facts before the courts. The paradigmatic fact pattern has involved the transfer of interests in closely held businesses or investment funds taking the legal forms of limited liability companies, general or limited partnerships, or corporations, whether "C" corporations subject to corporate income taxes, or "S" corporations not ordinarily subject to corporate income taxation.

Whenever ownership interests in these entities are transferred via gift or devise, the question arises whether, and to what extent, the interests' values for federal estate, gift and generation-skipping tax purposes (hereinafter "transfer taxes") are to be ascertained only by reference to the transferred interests' proportionate share of the entire enterprise value of the business or fund, or alternatively whether value starts with the enterprise value, followed by a downward adjustment owing to the lack of marketability of the interest,[1] and also because ordinarily the interest transferred does not represent a controlling interest in the business or investment fund. These decreases to the proportionate share of the enterprise value are commonly known as "valuation discounts".

Valuation discounts for transfer tax purposes have been the norm since before the 1990 Act. Chapter 14 and current regulations provide legal guidelines concerning the limitations on and acceptable scope of the valuation discounts for these purposes. Much of the case law scrutinizes the IRS' and taxpayer's valuation experts' reports reflecting differing valuation discounts. The cases are "the battle of the valuation experts" as led by their respective trial attorneys. Many settle without judicial opinions. The Federal court decisions have found valuation discounts in the 15%–65% range depending upon such factors as the nature of the business, the assets of the closely held entity under review, and the overall US economic climate as of the time of transfer. Longstanding IRS audit and appeals practice has been to propose downward adjustments (to the 25%–35% range) from higher percentage

discounts reflected in transfer tax returns.

In material part the IRS' administrative approach also flows from Revenue Ruling 93-12 (revoking Revenue Ruling 81-25's "family as single control unit" position). In Revenue Ruling 93-12, the IRS conceded the tax law does not support a notion that for purposes of ascertaining the value of a transferred non-controlling interest in a family enterprise, lack of control is to be determined not by looking at only the transferred interest, but by viewing the family as a whole. In other words, the IRS agreed that there is no ownership attribution of one family member's ownership interests to other family members. The proposed rules reverse this administrative ruling position, in effect proposing to return IRS administrative policy to that based on Revenue Ruling 81-25.

Valuation Discounts Attacked

The proposed rules purport to diminish if not entirely disallow the lack of marketability and lack of control valuation discounts in connection with gifts and devises of interests in closely held businesses and investment funds, but cleverly do not expressly state that intended result. They also beg the question of whether or not these discounts, actually in fact, depend upon state entity statutes or entity agreements that place restrictions upon transfers of interests or owners' receipt of assets upon liquidating distributions by entities. These complex considerations will make it difficult for the courts to construe the rules at the individual case level, if adopted "as is" as regulations. As of the time of this writing the proposed rules are intended by Treasury to be issued as regulations after public comments now being received by the Internal Revenue Service (on behalf of the Treasury). Treasury has stated the regulations will become effective only as of the date of their publication in the Federal Register, which means during December, 2016 at the soonest.

Will the Proposed Rules Apply to Current Actions?

An important question is whether or not a person in control of a closely held business or investment entity should make gifts of minority ownership interests before the effective date of regulations. (One ought not plan to die before that date.) Gifts before the effective date, however, give rise to an issue flowing from the proposed rules' position that the death of a transferor within 36 months after the date of a transfer (however effected) is treated "as if" the transfer had occurred on the date of death. Presumably then, the testing under the regulations for the gift tax value by disregarding ostensible value-reducing factors present on the transfer date would be undertaken by revenue agents even though the transfer occurred pre-regulations. This approach should be viewed as an affront to a large body of current law consisting of several "within three years of death" rules and other transfer tax valuation rules found *inter alia* in Sections 2035 and 2038 of the Code, the regulations thereunder and case law. The approach deserves to be problematic for the IRS. Nevertheless, only pre-regulation gifts made earlier than 36 months before a date of death provide certainty gifts will occur outside the scope of new regulations.

As an alternative to taxable or nontaxable gift transfers before any effective date, a transferor should consider taking an informed position on a tax return contrary to any regulations, as many attorneys including this author believe may be reasonably warranted for a variety of reasons beyond the scope of this short review. Of course, not until regulations are issued can such an informed position be taken, because Treasury may make relevant changes to the proposed rules. As a further alternative, especially if a gift tax would or could be due, a transferor could seek out valuation expertise that supports other valuation discounts. For example, discounts have been adduced for the costs associated with selling closely held minority interests, as well as selling fractional interests in real estate and art objects. However, these discounts have not been as routine as the lack of control and marketability discounts, and would ordinarily fall in the 5%–15% range. Discounts have also been adduced on account of the prospect of future corporate taxes to a hypothetical buyer of transferred stock in a closely held "C" corporation or an "S" corporation subject to one or more of the several "S" corporation special corporate level taxes. The proposed rules are entirely irrelevant to these other discounts that have been reflected on many tax returns, and in concept these discounts are supported by Federal court decisions.

> If the proposed rules are adopted, and if they are enforced by the IRS, this author predicts there will be significant litigation regarding their application no later than 2019.

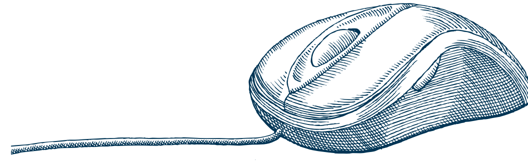
In addition, several years ago business valuation experts developed the "risk of ownership of non-marketable investment company" valuation method that departs from the industry's use of methods focusing on lack of marketability and control discounts in arriving at empirically demonstrated values for non-controlling ownership interests. This valuation method's current use is evident from such state court, non-tax fair value opinions as *In the Matter of Robert T. Giaimo v. Janet Giaimo Vitale*, 101 AD3d 523, 2012 NY Slip Op 08778 (1st Dept. 2013), (rev'g. trial court and holding 16% discount applicable to net real estate value because ownership of stock in this real estate holding corporation comes with more risk and cost than if the real estate itself were the subject of direct ownership and valuation). In light of this and perhaps other emerging valuation methods, since the proposed rules are directed at state statutes and partner, member or shareholder agreement provisions that arguably hinder sales of interests or the dissolution and liquidation of an entity's business or investment assets, the proposed rules seemingly fall short of their apparent goal: to greatly increase the Federal government's transfer taxes take.

Future of the Proposed Rules

As to the proposed rules' overall validity, in a nutshell, the Federal courts ought not grant *Chevron* deference to any finalized regulations. Oversimplified, *Chevron* deference refers to a 1984 Supreme Court case (and progeny) wherein the Court laid down a judicial doctrine to the effect that, if a Federal statute is ambiguous, the Federal courts shall defer to Federal agency regulations interpreting it. Absent *Chevron* deference, the Federal courts would be free to make independent evaluations concerning whether or not the regulations comport with the text of Chapter 14 in general, and Sections 2701 and 2704 in particular, and also the legislative history to Chapter 14. Absent *Chevron* deference, the courts are not constrained to "defer" to the "expertise" of the Treasury and IRS. The author does not believe that the Treasury has ever rewritten regulations of the importance of the current regulations as long as 24 years after adoption, and where they had become settled law and administrative policy. There is no judicial precedent for sustaining regulations meeting this fact pattern upon *Chevron* deference or other grounds. Many further sound arguments can be made such as that the proposed rules neither pass muster under the wording of Chapter 14, nor reflect the legislative history to Chapter 14. For example, the Conference Report describing Chapter 14 states, "…The bill does not affect minority and other discounts available under present law". That is a clear expression of Congressional intentions, if ever there was one. The current regulations reflect this intention; the proposed rules do not.

If the proposed rules are adopted, and additionally if they are in fact administratively enforced by the IRS, this author predicts there will be significant litigation regarding their application not later than 2019.

1. *A closely held business or investment fund by definition does not have ownership interests that trade in securities markets and therefore is not liquid.*



dealing with digital assets

DURING LIFE AND AFTER DEATH

by Anne Marie Robbins, Esq

Digital assets can present a challenge for fiduciaries. Items that 30 years ago would have had a physical existence, such as bank account statements, may now only exist in the digital realm. Because digital assets are intangible, identifying them and gaining access to them on behalf of their owners can be time-consuming and often, because this is a relatively new asset class and the rules governing it are still evolving, unsuccessful. Through planning, it is possible for individuals to take steps to protect what matters in their digital lives.

We live in a digital age. The advent of the personal computer, the rise of social media, online access to financial accounts and commerce, and the development of increasingly efficient programs and applications affording easy access to our finances, shopping, entertainment activities, and communications, have helped to create a world in which each of us likely spends a portion of most days online. The result is often a trove of digital assets that we have created, communicated, and stored. Some of these assets may have substantial inherent financial value (for example, frequent flyer miles and other award programs), some may have value because they are the means of accessing other assets (e.g., your bank account user name and password), and some may have sentimental value (such as your e-mail account holding personal correspondence).

Most service providers include their policies regarding deceased users' accounts in the terms of service provided when a user establishes the account, including what happens when the account owner dies. However, few people in practice pay attention to the provisions to which they are agreeing. It is sometimes the case that a service provider's terms of service will cause all access to terminate as a result of an account owner's death. Service providers are beginning to address the probability that many users would want someone to have access to the content the user has created or stored. For example, Google has an "Inactive Account Manager" function that allows users to determine what happens to the digital assets stored on Google sites after a period of inactivity. The user can request that Google either notify a specified individual and share information with that person, or can request that Google delete an account and its contents.

Uniform Fiduciary Access to Digital Assets Act

Several states, including Connecticut, Delaware, Florida, Idaho, Indiana, Michigan, Nevada, Ohio, and Rhode Island, have enacted laws to ensure that fiduciaries are provided the authority to access digital assets on behalf of an account owner. In New Jersey, Senate bill S2527, the Uniform Fiduciary Access to Digital Assets Act, has been referred to the Judiciary Committee for consideration. The Act would allow an executor, agent, guardian, or trustee to manage the electronic records of a decedent, principal, incapacitated person, or trust settlor.

> It is also sensible to keep a list, whether with the estate planning attorney or wherever the estate planning documents are maintained, of all digital assets and accounts along with user names and passwords.

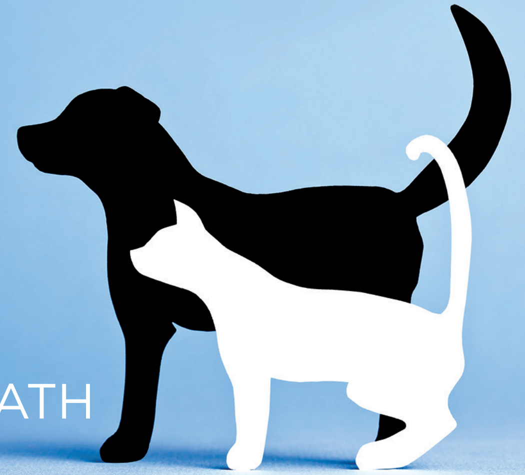
Under the Act, a user may use a service provider's online tool to direct or prohibit the disclosure of some or all of the user's digital assets. If the user does not do so, then the user's will, trust agreement, power of attorney, or other document may allow or prohibit a fiduciary's or other person's access. If the user has not provided any instructions in this regard, a fiduciary's access may be modified or eliminated by federal law or a terms of service agreement. Hence, even when the New Jersey Act passes, addressing access to digital assets in estate planning documents will continue to be important for many people.

Until the Act becomes law, it is not clear whether a New Jersey fiduciary would be considered by virtue of his or her fiduciary status alone to have authority over the digital assets of another. Therefore a power of attorney should grant an attorney-in-fact the specific power to deal with and administer all digital assets. Similarly, a will should include the power for an executor to access digital assets and deal with them after the owner's demise.

Planning Ahead

The uncertainties regarding whether the fiduciaries will be allowed access to digital assets reinforces the necessity in estate planning to think about and provide for such access. While in New Jersey it is arguable that one's fiduciaries should have access even if not specifically set forth in a governing instrument, providing the appropriate powers in the estate planning documents takes the guesswork away. Even if New Jersey passes the Uniform Access to Digital Assets Act, it may make sense to continue to include specific directions in one's estate planning documents about such access. Although the Act would generally grant to an executor the power to access all electronic records and assets, perhaps it would be appropriate for all adult children to also have access to certain assets, for example, to a decedent's Facebook account.

pet trusts



PROVIDING FOR YOUR PETS AFTER DEATH

by Jonathan S. Chester, Esq

In today's society, it's becoming increasingly common for our pets to be treated as part of the family… but what happens to your pet or pets upon your death when you are no longer there to care for them? In the eyes of the law, animals are considered property… so you can't leave money directly to your pet.

Establishing a Pet Trust

Pet owners should carefully consider how they intend to provide for the care and treatment of their pets following death. Failing to plan ahead and provide adequately could result in a pet ending up in an animal shelter… or worse.

When thinking about establishing a Pet Trust, important considerations include:

- Naming the trustee of the trust;
- Naming the caregiver for your pets;
- Deciding how much money to set aside in the trust to provide your pets with proper care for the rest of their lives;
- Designating the people (or better yet, the charitable organization) who will receive the balance of the trust fund upon the death of your pet or pets.

A Pet Trust can either be created and funded during your lifetime, or the terms of the trust can be included in your Will with the trust established and funded upon your death. It is very important to let family members as well as the caregiver and the trustee (the caregiver and trustee can be the same person) know your intentions in advance so that your pets are properly cared for in the confusion that often occurs immediately after the death of a pet owner. Confirm that your trustee and caregiver are willing to take on the responsibility. The caregiver (and perhaps an alternate caregiver) should know their role and responsibilities well in advance, so that they will be able to help provide for your pet or pets immediately following your incapacity or death.

Proper planning for the pet owner should include a careful discussion and adequate provisions for the care and maintenance of any pets. Where appropriate, the use of a properly drafted "Pet Trust" is a useful tool that can be employed to insure that pets are properly cared for following death or incapacity.

New Jersey Uniform Trust Code

On January 19, 2016, the legislature passed the New Jersey Uniform Trust Code (NJUTC), which became effective as of July 17, 2016. As part of the NJUTC revisions, modifications were made to the rules regarding the creation and use of "Pet Trusts."

New Jersey Uniform Trust Code (NJUTC) Details

1. A trust may be created to provide for the care of an animal alive during the settlor's lifetime. The trust terminates upon the death of the animal or, if the trust was created to provide for the care of more than one animal alive during the settlor's lifetime, upon the death of the last surviving animal.
2. A trust authorized by this section may be enforced by the settlor or by a person appointed in the terms of the trust or, if no person is so appointed, by a person appointed by the court. A person having an interest in the welfare of the animal may request the court to appoint a person to enforce the trust or to remove a person appointed.
3. Property of a trust authorized by this section may be applied only to its intended use, except to the extent the court determines that the value of the trust property exceeds the amount required for the intended use. Except as otherwise provided in the terms of the trust, property not required for the intended use shall be distributed to the settlor, if then living, otherwise to the settlor's estate.

New Jersey codified pet trusts in 2001 [NJSA 3B: 11-38]

Top 3 reasons that clients engage in planning

59% avoid probate

57% minimize discord among beneficiaries

39% protect children from mismanaging their inheritances

7th Annual Industry Trends Survey conducted by WealthCounsel and WealthManagement.com. (2014)

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