Planning for the New Jersey Inheritance Tax

By Jim Lynch

Most estate planners focus on federal estate tax issues; however, in recent years, the importance of federal estate planning has decreased, due to the $5 million exclusion being made permanent and indexed for inflation, as well as portability being made permanent (see Internal Revenue Code [IRC] sections 2010[c][2][A], [c][2][B], and [c][4]). Conversely, estate planning at the state level—particularly in those states that have decoupled from the federal estate tax, such as New York and New Jersey—has become more important.

In addition to an estate tax, New Jersey also has an inheritance tax (see New Jersey Statutes Annotated [NJSA] section 54:5-1). The inheritance tax is paid on bequests made to certain classes of beneficiaries. Rates can be as low as 11% and as high as 16% (NJSA section 54:34-2). The inheritance tax can act as a credit against the New Jersey estate tax (NJSA section 54:38-1[b]). As a result, inheritance tax planning is increasing in importance for those estates where the inheritance tax is equal to or greater than the New Jersey estate tax.

It is important for the tax advisors of individuals with property in New Jersey to familiarize themselves with the inheritance tax, as well as situations in which the inheritance tax will equal or exceed the New Jersey estate tax. This discussion offers planning techniques for minimizing and managing the New Jersey inheritance tax.

Overview of the Inheritance Tax

The New Jersey inheritance tax is imposed on the transfer of property by bequest to certain classes of beneficiaries. Four classes of beneficiaries exist:

- **Class A** beneficiaries are spouses, civil union or domestic partners, lineal ancestors, and descendants (whether natural or adopted) or stepchildren of the decedent (New Jersey Administrative Code [NJAC] section 18:26-1.1).
- **Class B** beneficiaries were eliminated by statute, effective July 1, 1963 (see the introduction to “Transfer Inheritance and Estate Tax,” p. 1 http://www.state.nj.us/treasury/taxation/pdf/other_forms/inheritance/itrins.pdf).
- **Class C** beneficiaries are collateral relatives—that is, brothers and sisters—as well as spouses, civil union partners, surviving spouses, or the surviving domestic partner of the decedent’s son or daughter (NJAC section 18:26-1.1).
- **Class D** beneficiaries are all other beneficiaries not covered by A, B, C, or E (NJAC section 18:26-1.1).
- **Class E** beneficiaries are certain governmental and not-for-profit organizations, including the State of New Jersey and any of its political subdivisions, and any “educational institution, church, hospital, orphan asylum, public library or Bible and tract society or to, for the use of or in trust for any institution or organization organized and operated exclusively for religious, charitable, benevolent, scientific, literary or educational purposes … no part of the net earnings of which inures to the benefit of any private stockholder or other
individual or corporation” (see NJAC 18:26-1.1).

Bequests to institutions outside of the United States and to educational institutions are not exempt unless the country or institution grants a similar exemption to bequests made to New Jersey institutions (NJAC 18:26-1.1). The instructions to the inheritance tax return make it plain that not all not-for-profit organizations (for IRS purposes) are considered Class E beneficiaries—for example, social clubs are not-for-profit organizations, yet they are not categorized as Class E beneficiaries (see the introduction to “Transfer Inheritance and Estate Tax,” p. 1).

Bequests to Class A beneficiaries are not subject to the inheritance tax (NJAC section 18:26-2.5). In some cases, except those in which a spouse is the sole beneficiary, those estates will be subject to the New Jersey estate tax (NJSA section 54.39-1[a]). Bequests to Class C beneficiaries are tax free up to $25,000 per beneficiary. Rates begin at 11% for bequests greater than $25,000 and increase to a maximum of 16% on bequests greater than $1.7 million (NJAC section 18:26-2.7). Bequests to Class D beneficiaries are tax free if they are less than $500 (see the schedules of “Transfer Inheritance and Estate Tax,” p. 4). Bequests greater than $500 are taxed at 15%, up to the first $700,000; any excess is taxed at 16% (see the schedules of “Transfer Inheritance and Estate Tax,” p. 4).

A Credit Against the Estate Tax

As previously mentioned, there is a credit against the New Jersey estate tax for any inheritance tax (see NJAC section 18:26-3.2[a]). The inheritance tax is imposed on the value of real or tangible personal property located in New Jersey and, in the case of a resident, all intangible property, wherever it is located. In the case of a nonresident, the tax is imposed only on real or tangible personal property located in New Jersey (see NJAC sections 18:26-5.2[a] and 5.2[b]).

The New Jersey inheritance tax applies not only to testamentary dispositions but also transfers made in contemplation of death. A transfer by deed, grant, bargain, sale, or gift made more than three years before the decedent’s death is not considered to be in contemplation of death; however, any such transfer made within three years of death is considered to be made in contemplation of death and is taxed accordingly, unless the contrary can be proven (see NJSA sections 53:34-1 and 18:26-5.7; this issue will be discussed in greater detail in a later section).

The New Jersey estate tax has a highly progressive rate structure, with a top rate of 16% (see instructions to New Jersey Form IT-Estate, “Resident Decedent Estate Tax Return”). The inheritance tax has a much less progressive rate structure but has the same top rate (see instructions to New Jersey Form IT-R, “Inheritance Tax Return Resident Decedent”). Therefore, if the entire estate is subject to both the New Jersey inheritance tax and the New Jersey estate tax, the former will generally be higher; this makes inheritance tax planning even more important, regardless of the estate’s size.

Planning Tips

Although the New Jersey inheritance tax might appear all-encompassing, planning opportunities do exist. First, the proceeds of a life insurance policy on the decedent are not taxable as long as the proceeds...
are payable to one or more named beneficiaries, other than the estate or the executor or administrator of the decedent’s estate. Alternatively, the proceeds may be made payable to the trustee of a trust created under the decedent’s will (NJSA sections 54:34-4 [c] and [f]).

The New Jersey estate tax, on the other hand, taxes life insurance proceeds in the same manner as the federal estate tax (see instructions to Form IT-Estate, p. 1). Therefore, proceeds payable to an individual beneficiary could be subject to the New Jersey estate tax; proceeds payable to a trust, however, would not be subject to this tax (NJSA section 54:34-11).

**Life insurance.** This inheritance tax provision creates a valuable planning tool. It may behoove taxpayers to have life insurance paid to beneficiaries whose inheritances will be subject to the highest taxes. For example, consider an estate with a $1 million life insurance policy and $1 million in cash. Two beneficiaries will divide the estate equally—a brother (a Class C beneficiary) and a nephew (a Class D beneficiary). If the brother is the named beneficiary of the life insurance policy and the nephew receives the $1 million in cash, the tax will be computed as shown in Panel A of the Exhibit. On the other hand, if the nephew is the beneficiary of the life insurance policy and the brother receives the $1 million in cash, the tax is computed as shown in Panel B. This simple planning technique, which appears somewhat counterintuitive, will save about $46,000 in taxes. A simple analysis of the difference will show that, even with lesser sums, the savings can be significant (Panel C).

**Gifts made in contemplation of death.** A second planning opportunity involves the rule that gifts made within three years of death are, without evidence to the contrary, presumed to have been made in contemplation of death and are added back to the estate (NJSA section 54:34-11). The burden is on the taxpayer to show that a gift was not made in contemplation of death. This is a question of fact, and one of the most important factors is the donor’s motivation in making the gift (see *Swain v. Neeld*, 28 NJ 60, 65 [1958]).

This is similar to the federal rule that existed until 1976, which also required the adding back of gifts made in contemplation of death if made within three years of death. Like the New Jersey rule, the federal rule had a rebuttable presumption that all gifts made within three years of death should be added back (see Lawrence Brody, Richard L. English, and Lucinda A. Althauser, “Section 2035 Transfers,” *Tax Management Portfolios*, vol. 818, citing IRC section 2035, as in effect in 1954).

In 1976, Congress changed the law and simply required all gifts made in three years of death to be added back to the estate. However, the state law has retained the rebuttable presumption.

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**EXHIBIT**

Planning for the Inheritance Tax: Calculations

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<thead>
<tr>
<th>Panel A</th>
<th>Life Insurance $1,000,000</th>
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<tr>
<td>Cash $1,000,000</td>
<td>Tax $700,000 at 15%</td>
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<tr>
<td>$300,000 at 16%</td>
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<th>Panel B</th>
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<th>Tax $0</th>
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<tr>
<td>Cash $1,000,000</td>
<td>Tax $25,000 exempt</td>
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<tr>
<td>Tax $975,000 at 11%</td>
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<tr>
<td><strong>Total</strong></td>
<td>$107,250</td>
<td></td>
</tr>
</tbody>
</table>

**Panel C:**

The difference is computed as follows:

- $25,000 at 15% $3,750 The first $25,000 is exempt for C beneficiaries.
- $675,000 at 4% $27,000 The difference between the D rate of 15% and the C rate of 11% on $75,000.
- $300,000 at 5% $15,000 The difference between the D rate of 16% and the C rate of 11% on the final $300,000.
- $1,000,000 $45,750 Total

If $200,000 was the amount of life insurance involved, the savings would be $10,750:

- $25,000 at 15% $3,750
- $175,000 at 4% $7,000
- $200,000 $10,750 Total
years of death to be added back. This was done to eliminate the considerable litigation that had arisen as a result of the rebuttable presumption that all gifts made within three years of death were made in contemplation of death (see Brody et al., citing the House Ways and Means Committee report on the Tax Reform Act of 1976).

In Swain v. Neeld, the New Jersey Supreme Court discussed the criteria for determining whether a gift was made in contemplation of death:

Relevant factors to be considered ... include, but are not limited to: the age and general condition of health of the donor at the time of making the gift; the time interval between the inter vivos transfer and death; the existence of a desire to evade inheritance taxes; whether or not the inter vivos transfer was part of a testamentary scheme or plan; past history of substantial gifts by the donor; whether or not the gift was made to the natural objects of the donor’s bounty; whether or not there existed an emergency situation which may have prompted the donation (e.g., donee’s illness requiring large expenditures) (http://nj.findacase.com/research/wfrmDocViewer.aspx/xq/19581020_0040100.nj.htm/qx).

According to the court’s decision in Swain v. Neeld, the state does not need to show that contemplation of death was the only motive; it merely needs to show that contemplation of death was an impelling, or important, motive in the decision to give the gifts (p. 69).

Planners can suggest that clients set up a regular gifting program to individuals who are not beneficiaries under the donor’s will. If such a program is in place for a sufficient length of time, there is a strong likelihood that it will not cause gifts made within three years of death to be included in the taxable estate for inheritance tax purposes.

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The court decided in favor of the state, concluding that the state was entitled to add the gifts to the inheritance tax basis.

Reducing the Burden

As demonstrated in this discussion, the New Jersey inheritance tax can represent a significant burden for taxpayers, distinct from federal estate taxes. With careful planning, however, the burden can be ameliorated for heirs.

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