Till Death Do Us Part: Preparing for State Estate Tax

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May 2016

Tax-wise, 2010 was a great year to die (just ask George Steinbrenner's family). At the time, Congress repealed the so-called "death tax" which today carries a top tax rate of 40% on estates over $5.45 million (indexed annually for inflation). Keep in mind however that this exclusion applies only to *federal* taxes which are often supplemented by estate taxes levied on the *state* level as well. Today, two of the most taxing states in the country to die in are New Jersey and New York.

New Jersey is home to roughly 9 million people and the 2nd highest median household income in the country. Unfortunately it also imposes the country's highest property tax rate and, even worse, lowest state estate tax exemption at a measly $675,000. In other words, estates valued at over $675,000 pay state taxes *in addition* to federal taxes up to a top marginal rate of 16%! On a side note, New Jersey is also one of only twelve states that imposes an *inheritance tax* to certain beneficiaries as well (although that is topic for another discussion).

New York carries a somewhat higher state estate tax exemption of $4.1875 million and in 2014 passed a law that will gradually raise this exemption annually through 2018 to $5.25 million. Here's the catch though – if your estate is valued at 5% or more over this threshold (roughly $5.5 million or higher), the *entire* exclusion is eliminated and the state taxes every dollar! Talk about a steep cliff. The top marginal tax rate for New York estate tax is also 16%.

So, what can be done to help soften the blow? In 2010, Congress introduced a law that allows a spouse's unused estate tax exemption upon death to be transferred to the surviving spouse to use in the future. The American Taxpayer Relief Act of 2012 later made this concept (known as "portability") a permanent component to the tax code. But again – this portability election applies to *federal* estate tax exemptions only. That said, below are some recommendations for how to reduce your overall estate tax liability (particularly on the state level).

- **Use a Credit Shelter Trust (also known as a Bypass Trust or AB Trust)**. These trusts are designed to provide a solution to portability on the state level. A common strategy is to fund a credit shelter trust with an amount equal to one's state tax exemption ($675,000 in NJ or $4.1875 million in NY) for the benefit of the surviving spouse and remainder going to the kids. This essentially "ports" the state's estate tax exemption to the surviving spouse while still providing income from the trust as needed. In addition, any future appreciation that occurs within the trust is excluded from the surviving spouse's estate.

- **Move to Florida!** While this is more of a lifestyle decision than a financial one, the fact of the matter is that Florida is one of the tax-friendliest states in the country and imposes no estate tax on the state level (or income tax, or inheritance tax). It's no wonder the state is home to the highest percentage of people over 65 in the country!

- **Outright gifts**. As obvious as this sounds, many people fail to take advantage of the $14,000 annual gift exclusion ($28,000 for married couples). If you're already planning to pass down assets to your children or other heirs, consider setting up trusts and contributing to them annually. Make sure the trusts are *irrevocable* to ensure they are excluded from your estate (revocable trusts are brought back into your estate upon death for tax purposes).

- **Life insurance (in a trust).** Combining a life insurance policy with an Irrevocable Life Insurance Trust (ILIT) is one of the most powerful estate planning strategies that exists today. By purchasing a life insurance policy and naming the ILIT as the beneficiary, the proceeds are excluded from the decedent's estate and paid to the trust income-tax free. There are no estate taxes, no inheritance taxes, and no income taxes (on both the federal and state levels).

In summary, estate taxes can be burdensome on many levels, particularly for those in New Jersey and New York. Please speak with your Client Advisor about ways to help reduce your estate tax liability within the context of your overall financial plan.

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