

DOES INCLUSION OF AN ASSET FOR NJ ESTATE TAX PURPOSES RESULT IN AN NJGIT STEP-UP IN BASIS?

Prepared By: Bruce E. Mantell, CPA, Esq., LLM

2010 Federal Carry Over Basis Election

A step-up in tax basis for New Jersey Gross Income Tax (NJGIT) purposes is uncertain with respect to those assets for which a 2010 Federal carry over basis was elected by filing Form 8939 (Allocation of Increase in Basis for Property Acquired From a Decedent), notwithstanding the imposition of a New Jersey Estate Tax at fair market value on the assets reported on Form IT-Estate (State of New Jersey Resident Decedent Estate Tax Return) and the Deemed December 31, 2001 Form 706 (U.S. Estate (and Generation-Skipping Transfer) Tax Return). This scenario is real and will present itself in a number of situations resulting from the unique application of the retroactive 2010 Federal Estate Tax law, the election out of the Federal Estate Tax and the decision to have the carry over basis rules apply.

NJ Only QTIP Trust

The NJ Division of Taxation allows a NJ Only QTIP Trust to be carved out of the Federal Credit Shelter Trust if no federal Form 706 is required to be filed. This election allows the NJ Estate to pay no Estate tax at the death of the first spouse while still fully funding a Federal Credit Shelter Trust. This is happening more and more in NJ as the federal death exemption has sky-rocketed from \$1,000,000 in 2002 to \$5,340,000 in 2014 (with the prospect of further increasing every year). Many first spouse Estate administrations in New Jersey face this issue when a NJ Only QTIP Trust can be sculpted out of the Federal Credit Shelter Trust. So at the death of the surviving spouse, the Federal Credit Shelter Trust is not included in the surviving spouse's estate for Federal Estate Tax purposes and, of course, no step up in basis of the assets in the Credit Shelter Trust occurs for Federal Income Tax purposes. But, if the surviving spouse remains a NJ resident, the NJ Only QTIP portion of the Credit Shelter Trust is included in the surviving spouse's estate for NJ Estate Tax purposes (along with the surviving spouse's individual assets). The question is whether the assets in the NJ Only QTIP portion of the Credit Shelter Trust qualify for a basis step up for NJGIT purposes. Consider that all the assets in the NJ Only QTIP Trust are included on the Form IT-Estate and Deemed December 31, 2001 Form 706 at fair market value and are subject to the NJ Estate Tax. Is it possible that only the individually owned assets qualify for a NJGIT step up in tax basis, but the assets in the NJ Only QTIP portion of the Credit Shelter Trust do not?

NJ Division of Taxation Position

The NJ Division of Taxation has not yet publicly commented on this issue. There is not yet any specific case law. But it has been confirmed that the NJ Division of Taxation has been informally asked what position it will take and the NJ Division of Taxation predictably has advised the inquirers by telephone that Federal Income Tax basis will control (in both scenarios).

Statutory Analysis - New Jersey Estate Tax

This result is consistent with the technical interpretation of the 2002 NJ Estate Tax statute which relies on the Federal Estate Tax law as it existed on December 31, 2001. It specifically states at N.J.S.A. 54:38-1 that “there is hereby imposed an estate or transfer tax upon the transfer of the estate of every resident decedent dying after December 31, 2001, which would have been subject to an estate tax payable to the United States under the provisions of the Internal Revenue Code of 1986 (26 U.S.C. s. 1 et seq.), in effect on December 31, 2001.”

Statutory Analysis - New Jersey Gross Income Tax

It is also consistent with the technical interpretation of the New Jersey Gross income Tax Act which provides that New Jersey gross income shall consist of fourteen categories. One of those categories is the “net gains or income that arise from the disposition of property. That category of income is addressed in N.J.S.A. 54A:5-1(c) which provides in pertinent part that net gains or net income, less net losses, derived from the sale, exchange or other disposition of property, including real or personal, whether tangible or intangible shall be determined in accordance with the method of accounting used for Federal Income Tax purposes. For the purpose of determining gain or loss, the basis of property shall be the adjusted basis used for Federal Income Tax purposes.”

Uniqueness in the Application of the New Jersey Estate Tax in Certain Scenarios

Relying on the Federal Estate Tax law as it existed on December 31, 2001 and the NJGIT law, taxpayers in NJ have experienced a number of unique situations which cause unfair and inequitable results under both the NJ Estate Tax law and the NJGIT law. Generally, although admittedly distinguishable from the NJ Estate Tax and NJGIT basis conundrum discussed above, there are two important NJGIT cases which have held that the NJGIT does not have to follow the Federal Income Tax basis rules. These cases give hope to the proposition that the tax basis of assets subject to the 2010 Federal estate carryover basis election or held by a NJ Only QTIP Trust qualify for a step up in tax basis for NJGIT purposes, notwithstanding the NJ Division of Taxation position to the contrary.

NJGIT Cases

One case was in the S Corporation context (Walsh v. Director, Division of Taxation, 10 N.J. Tax 447, 240 N.J. Super 42, 572 A.2d 222 (App. Div. 1990)) and the other case was in the partnership context (Koch v. Director, Division of Taxation, 17 N.J. Tax 34, 157 N.J. 1; 722 A.2d 918). Both cases dealt with the gain on sale of the entity interests, the basis of which had been adjusted downward by loss recognition for Federal Income Tax purposes. Since the NJGIT law did not allow the losses to be taken as a deduction for NJGIT purposes the Court held that the tax basis of the entity for NJGIT purposes was not reduced (as it was for Federal Income Tax purposes) and, therefore, the NJGIT gain on the sale of the entity interests was significantly less than the capital gain recognized on the sale of the entity interests for Federal Income Tax purposes.

NJ Estate Tax Case

There is also an important NJ Estate Tax case which held that the application of the Federal Estate Tax law to the facts in the case was “manifestly unjust” and the NJ Tax Court held in favor of the Taxpayer (Oberhand v. Director, Division of Taxation, 22 N.J. Tax 55 (2005)). The issue concerned the retroactivity of the July, 2002 changes to the NJ Estate Tax law to January 1, 2002 as it specifically impacted the situation at hand. This is, of course, also admittedly distinguishable to the two headed NJGIT basis conundrum. But again, the decision gives hope to the New Jersey taxpayer that the unfair and inequitable informal position of the NJ Division of Taxation against NJGIT basis step up in connection with 2010 federal carry over basis and NJ Only QTIP scenarios will ultimately be rejected by the Court.

Future Prospects of NJ Tax Court Decision

It is almost a certainty that in the right case (significant NJ Gross Income Tax at stake and/or involvement of a motivated anti-tax advocate) there will be NJ Tax Court litigation over these issues. It is simply a matter of time. And, hopefully, the NJ Tax Court will come to the just result that not allowing a tax basis step up for NJGIT purposes is unfair and inequitable since both NJ Estate Tax and NJGIT will be imposed on the same assets (a double tax). The scenarios presented by the 2010 federal carry over basis election and the NJ Only QTIP Trust were simply not contemplated when the new NJ Estate Tax law was enacted in July, 2002.