New Jersey Law Journal

VOL. CLXXXII – NO. 7 – INDEX 671 NOVEMBER 14, 2005 ESTABLISHED 1878

FINANCIAL PLANNING

Estate Planning for Same-Sex Couples

Why the NJDPA doesn't solve all problems

By Gary R. Botwinick

According to the Year 2000 U.S. Census, there were 601,209 same-sex unmarried households in the United States. In fact, though there is no way to obtain an exact count, the lesbian and gay population in the United States has been calculated to be anywhere from 5 percent to 10 percent. This population is often under-served in the area of estate planning.

Though challenges in planning for same-sex partners are numerous and significant, the goals are typically the same as they are for married couples. Special attention must be given to financial, family and health issues that may be elementary in a traditional family (i.e. husband, wife and children). Further complicating the planning is the uncertainty regarding the future of the federal estate tax (which is scheduled to be temporarily repealed on Jan. 1, 2010, only to reappear on Jan. 1, 2011) and the different recognition given to these relationships across the several states.

On July 10, 2004, the New Jersey Domestic Partnership Act (NJDPA) (P. L. 2003, c. 246) went into effect. This new legislation was intended to provide same-sex partners (and in some limited circumstances, heterosexual relationships) with some of the legal benefits previously reserved only to married couples. The legislation was heralded as ground-breaking. However, the NJDPA has significant limitations and comes well short of accomplishing anything resembling a marriage. Moreover, the NJDPA does not provide any benefits to domestic partners for purposes of federal law. In fact, the Federal Defense of Marriage Act (DOMA) (Pub. L. 104-199, Sept. 21, 1996, 110 Stat 2419) provides that "no State shall be required to give effect to a law of any other State with respect to a same-sex 'marriage.'" 28 U.S.C. § 1738C. DOMA also states that for purposes of federal law "the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife." (1 U.S.C. § 7). As such, NJDPA is significantly limited in the benefits that it provides to same-sex partners.

While the mechanics of accomplishing the client's objectives may differ from heterosexual married couples, when representing same-sex couples, planners must still focus on the goals of the client, the limits of the law and the impact of estate and inheritance taxes. Certain common planning techniques used for husbands and wives are unavailable to same-sex couples, thus making the planning more complicated.

While this article cannot possibly address all issue relevant to estate planning for same-sex couples, the article focuses on those areas of the tax and probate laws that require the greatest attention. Only through effective planning and drafting can the clients' goals be effectively and efficiently accomplished.

Tax Issues

Married couples enjoy the benefit of an unlimited marital deduction for federal and New Jersey estate taxes, effectively eliminating any estate tax on transfers between spouses. (26 U.S.C. 2056(a)). For New Jersey inheritance tax purposes, married couples are considered "Class A" beneficiaries and transfers between them are exempt from inheritance taxes. (N.J.A.C. 18:26-2.5(b)). Moreover, step-children of a decedent are likewise considered "Class A" beneficiaries. (N.J.A.C. 18:26-1.1).

For purposes of the federal Generation-Skipping Tax, a spouse is assigned to the same generation of the deceased spouse. As such, regardless of the difference in the ages between the spouses, no generation-skipping tax will be imposed on transfers between the spouses.

Botwinick is a partner with of Einhorn, Harris, Ascher, Barbarito, Frost & Ironson of Denville.

Similar to the unlimited marital deduction for federal estate taxes, the Internal Revenue Code provides an unlimited marital deduction for federal gift taxes. (26 U.S.C. § 2523(a)). Thus, any transfers between spouses will be exempt from federal gift tax.

For same-sex couples, the tax laws are quite different. There is no unlimited marital deduction for federal estate tax purposes or gift tax purposes. In fact, there is no deduction available at all. A transfer to a life-partner is tantamount to a transfer to a stranger. At death, the deceased partner may only transfer $1.5 million ($2 million for the year 2006) before federal estate taxes are imposed. Any bequest in excess of this amount left to a surviving partner is subject to the federal estate tax rates that are currently 45 percent to 47 percent. (26 U.S.C. §2001(c). Thus, in 2005, leaving a taxable estate of $3 million to a life-partner will result in a federal estate tax of over $600,000. That same bequest to a spouse would have resulted in no federal estate tax. Because of the DOMA, these results would apply even if the life-partners were considered Domestic Partners under the NJDPA.

New Jersey's estate tax (which is loosely based upon the federal estate tax system in effect in 2001) likewise does not provide a marital deduction to life-partners. Even if the partners are Domestic Partners under the NJDPA, they are considered strangers to each other for purposes of New Jersey's estate tax. Thus, in addition to the federal estate tax imposed upon the estate mentioned above, a New Jersey estate tax in the amount of $182,000 would be imposed.

The NJDPA does provide relief to Domestic Partners for purposes of the New Jersey Inheritance Tax by treating them the same as spouses — New Jersey Inheritance Taxes do not apply to transfers between domestic partners. (N.J.S.A. 54:34-2). However, if the life-partners do not register as "domestic partners," the inheritance tax laws treat life-partners as Class D beneficiaries, with taxes imposed at rates of 15 percent to 16 percent upon the entire bequest. Notwithstanding the benefits that the NJDPA does provide to domestic partners for inheritance tax purposes, transfers to the children of a domestic partner are generally considered transfers to Class D beneficiaries, as opposed to transfers to step-children, who are considered Class A beneficiaries. Thus, these transfers are subject to New Jersey inheritance taxes.

Though rarely an issue, federal Generation Skipping (GST) Tax may also discriminate against same-sex couples. The GST tax is imposed upon transfers to persons who are assigned to a generation which is two or more generations below the transferor. 26 U.S.C. § 2601, et seq. Each individual receives a lifetime exemption from the GST tax (currently $1.5 million). 26 U.S.C. § 2631. Generally, when bequests are made to lineal descendants of a common ancestor, it is easy to determine the generational assignment. For transfers to spouses, regardless of the difference in the age of a husband and wife, they are assigned to the same generation. 26 U.S.C. § 2651(c). However, in same-sex relationships, the parties are considered strangers to each other. As such, the nonlineal descendant generational assignment rules apply. For purposes of the GST tax, if the beneficiary is more than 37.5 years younger than the decedent, the beneficiary is assigned to a generation that is two generations below the decedent. 26 U.S.C. § 2651(d). So, where a decedent (age 85) leaves his $3 million dollar estate to his life-partner (age 47), the amount of the net bequest in excess of the $1.5 million exemption is subject to GST tax.

Using the hypothetical example above, a $3 million estate left to a life-partner (who has not registered as a domestic partner under NJDPA) will result is federal estate taxes of $477,960, New Jersey inheritance taxes of $473,000, and Federal GST taxes of $178,000. Thus, the estate would be subject to taxes of $1,128,960, in the aggregate. A husband leaving this estate to his wife would pay no taxes at all.

Planning Issues

As difficult as the issues may be in planning the estate for married couples, the issues are significantly more complicated in same-sex relationships. Moreover, the planning is even more important for same-sex couples because of the lack of legal protection provided to surviving partners compared to that afforded a widow or widower. While the NJDPA was certainly a watershed event for same-sex couples, the act falls far short of recognizing the relationship as a marriage.

Last Will and Testament: The NJDPA does not provide any inheritance rights among partners. Consequently, it is extremely important that the partners execute last wills and testament addressing the rights and benefits to be provided to the surviving partner. A properly drafted will permits an individual to not only designate how their estate will be distributed, but also who will be responsible for ensuring that the individual's wishes are properly carried out by naming the surviving partner as the executor of the estate.

Frequently, in same-sex couples, extended families' feelings about the relationship and the partner can create animosity, resentment and confusion that can boil over after the death of one of the partners. It is imperative that planning for these couples addresses the roles, rights and responsibilities of the surviving partner and the extended family.

In the event that the surviving partner is not appointed as the executor, New Jersey law does not provide the surviving partner with any rights to be appointed as the administrator of the estate. This is the case even where the parties are domestic partners under the NJDPA. Thus, in the absence of an appointment under a valid will, a member of the decedent's extended family is likely to be appointed as the administrator of the estate.

New Jersey's Probate Code sets forth the manner in which a decedent's estate will be distributed in the event of an intestacy (death without a will). The spouse typically is entitled to at least in excess of one-half of the estate in all circumstances, and up to the entire estate in many circumstances. (N.J.S.A. §3B:5-3). The NJDPA makes no provision for a domestic partner in the case

of intestacy. Thus, a domestic partner is entitled to nothing upon the intestate death of his partner. In fact, in an intestate estate, first cousins and their children would have greater rights to the estate than would a surviving domestic partner.

Thus, a properly designed and executed last will and testament is of paramount importance.

Powers of Attorney: What happens if a life-partner is disabled and incapable of handling his own financial affairs? It will be necessary for another individual to act on behalf of the disabled partner. Typically, an individual can, in advance of such event, designate who would act on his behalf. This appointment is effectuated by a power of attorney wherein an agent is appointed to act for the incapacitated individual. Often, married couples appoint each other. Likewise, life-partners should name each other as agents under a durable power of attorney.

What if a person becomes incapacitated and does not have a power of attorney? Usually, a guardianship proceeding would commence and a court would have the authority to designate another individual to act for the incapacitated person. The New Jersey Probate Code provides that the incapacitated person's spouse will have the first right to be appointed as the guardian, and in the absence of a spouse, the incapacitated person's heirs will have a right superior to any other individual. Because a domestic partner does not have any intestate succession rights, he is not an heir and will stand in an inferior position to the incapacitated person's extended family.

Thus, a power of attorney is extremely important in same-sex relationships.

Living Will (Advance Directive/Health Care Proxy): In the past year, the significance of having a living will was thrust into the national spotlight as a result of the unfortunate circumstances of Terri Schiavo. The term "living will" often is used to refer to two documents: an advance directive and a health care proxy.

An advance directive is a written expression of an individual's desires regarding the administration of medical treatment and heroic measures if the individual is incapable of expressing his desires in the future. A health care proxy is a document wherein an individual grants authority to another to make medical decisions for that individual.

Because ill feelings among extended family members are often present in same-sex relationships, and those families often refuse to recognize the relationship, these instruments are even more important than they would be in marriages. Additionally, since the laws of the several states may differ in their recognition of domestic partners, it is prudent to execute these documents to minimize conflicts.

Since some hospitals restrict visitation rights to "family" members, life partners should also consider including provisions in the living will which authorize the partner to visit with the disabled individual and to select and restrict the rights of other family members to visit.

Irrevocable Life Insurance Trusts: Typically, insurance policies are owned by the insured individual, resulting in the inclusion of the life insurance policy death benefit in the insured's taxable estate. With a large policy, significant taxes could result. Because there is no unlimited marital deduction available to life-partners, insured-owned policies payable to the life-partner could result in a significant estate tax burden. Establishing an irrevocable life insurance trust for the benefit of the life-partner, and naming the trustee as the owner of the policy, will allow the death benefits to pass free of estate, inheritance and income taxes. This technique is also particularly helpful in providing liquidity to pay any taxes imposed on other assets passing upon death. This can be the most effective tax-savings device available to life-partners.

Grantor Retained Income Trusts (GRIT): In large estates, it is often necessary to utilize more advanced techniques to reduce estate tax liabilities. One technique that is often implemented is a GRIT. A GRIT is a "split-interest" trust where one party owns the income interest and the other party owns a remainder interest. The GRIT is such a wonderful estate planning technique that the tax laws prevent its use in a traditional family context. That means that a parent cannot establish a GRIT for the benefit of his children (except when funded with a personal residence). However, since the law considers life-partners as strangers to each other, the GRIT is a highly effective device for transferring assets to a life-partner at a significant discount for estate and gift tax purposes.

In a typical GRIT, a grantor will establish a trust and reserve for himself the right to the income from the trust for the shorter of a term of years or his life. At the end of the term, if the grantor is still living, the remaining principal in the trust will be distributed to the remainderman or continue to be held in trust for the beneficiary. However, the entire remaining balance will be excluded from the grantor's estate.

For example, if a 50-year-old grantor funds a 10-year GRIT with a gift of $1 million when the applicable federal interest rate is 5 percent, and names his life-partner as the remainderman, the value of the gift is $568,500. However, at the end of the term of the trust, assuming an annual return on investment of 5 percent, the value of the remainder interest will be $1,630,000. Thus, a gift of $568,000 results in $1,630,000 passing out of the estate. This can be an extremely effective means for passing wealth to a life-partner and should be considered in large estates.

Summary

In addition to the documents and techniques discussed above, when representing same-sex couples, additional documents should be considered (e.g. domestic partnership agreements, transfer-on-death accounts, family limited partnerships). Moreover, in situations where a child is born or adopted by one or both of the partners, additional time and attention should be focused on the care and support of the child in the event of the death or disability of one of the partners.

Planning for same-sex couples is

complex. This area of law is constantly changing as a result of new domestic partner legislation, tax legislation and other related areas of the law. But planners must focus on the end game — accomplishing the client's objectives effectively and efficiently; the same goals planners hope to accomplish when representing married couples. ■