SHERMAN WELLS
SYLVESTER & STAMELMAN LLP

TAX AND TRUSTS & ESTATES UPDATE

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Trustees Beware: Trust-Owned Life Insurance Needs a Regular Review to Avoid Trustee Liability

The irrevocable life insurance trust has historically been one of the most popular estate planning techniques, used as a relatively simple way to prevent death benefits from being subject to federal or state estate taxes. Often, the trustee is a trusted family member who may not even be aware of the fact that he or she has fiduciary duties to the beneficiaries of the trust. Some insurance trustees have even been known to forget that they are serving as a trustee. Regardless, all trustees are duty-bound under state law to review and manage all trust assets prudently for the benefit of the beneficiaries. That means, among other things, keeping a vigilant eye on the integrity and fiscal soundness of the life insurance policies owned by the trust.

Here are some rather disturbing statistics about life insurance policies in general:

- 69% have not been reviewed in the past five years
- 20% of these unreviewed policies are likely to lapse in the next three to seven years
- 40% of all "non-guaranteed" trust-owned life insurance policies will lapse during the insured's lifetime

It is therefore imperative that any trustee of a trust owning life insurance have the policies in the trust reviewed on a regular basis by a qualified insurance professional or by a service that specializes in policy reviews. Any costs associated with these policy reviews would be an appropriate trust expense. In practice, we have unfortunately witnessed carrier insolvency, policies that have lapsed without the knowledge of the trustee, and lawsuits against trustees when insurance proceeds were less than what the beneficiaries had expected. Since problem policies might have very large face values, the magnitude of the trustee's personal liability exposure may be quite significant.

While a review as frequently as annually is probably not necessary, a trustee should certainly review trust-owned policies every few years. That review should include the following: (1) reviewing the policy itself, including obtaining an updated "in-force illustration" from the carrier to see if the premiums are adequate to sustain the policy; (2) reviewing the insured's health or other factors that might impact the pricing of possible replacement insurance in a favorable way (e.g., the insured stops smoking); (3) reviewing the policy to confirm that it is still competitively priced compared to other products available in the marketplace; and (4) reviewing the financial strength of the company that issued the policy.

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The good news is that this review process can sometimes produce an opportunity for a substantial increase in trust death benefits or reduced premium payments for the same trust death benefit. Further, it may give the trustee confirmation that the policy value outweighs the expenses and remains a prudent investment. Perhaps more importantly, it provides a trustee with the peace of mind that he or she is actively managing the life insurance policies for the benefit of the trust beneficiaries. And, finally, the fact that the trustee has regularly reviewed the trust-owned policies may provide a defense against liability in the event that some unforeseen problem arises with a policy.

The bad news is that, if the trustee has not been doing regular policy reviews, he or she is inviting liability if anything goes awry with an insurance policy owned by the trust.

Finally, we would urge all trustees to regularly consult with their professionals to help ensure that they are executing their fiduciary duties to the fullest extent.

Tax Alert: No Estate Tax in New Jersey Doesn't Mean No Estate Administration

Following the full repeal of the New Jersey estate tax, effective as of January 1, 2018, it is important to remember that the need for estate administration remains the same. What follows is a list (and by no means, an exhaustive one) of important items that our experience has taught us are frequently overlooked when estates are handled "informally" by executors (if the decedent left behind a valid will) or administrators (if there is no will), without the involvement of adequate counsel:

- **Probate of the Decedent's Will**: The original of the decedent's will should be located and deposited with the surrogate's court of the county in which the decedent resided upon his or her death. Each surrogate's office is operated somewhat differently, but there is typically additional information that must be provided in order to have the will "probated" (adjudged by the court to be valid) and an authorized representative, known as an executor, who is named in the will, appointed to conduct business on behalf of the estate. If there is no will, then the surrogate's court will provide guidance as to the steps to appoint an authorized representative of an estate, known as an administrator (usually a surviving spouse, the decedent's surviving child or children, or in some cases, the decedent's closest living relative or relatives). The executor and administrator are commonly referred to as "fiduciaries" (and we will refer to them as such in this article) because of the special duty they have to faithfully administer the estate in accordance with the Decedent's will and state law. The will (if any) should be reviewed to determine the identity of the beneficiaries, whether or not any trusts will be created, and whether or not any disclaimers (more on those below) may be appropriate. It should also be noted that for real property owned outside the state of the decedent's residence upon his or her death, probate may be necessary in such other jurisdictions to effectively dispose of or retitle any such real property.

- **Basic Administrative Tasks:** At the very beginning of an estate administration, there are a series of basic administrative steps that must be completed. The decedent's mail should be forwarded to an address where it can be monitored. Credit cards should be cancelled and the Social Security Administration should be notified of the decedent's death (occasionally, the funeral home will notify the Social Security Administration). The major credit reporting agencies should be notified of the decedent's death and the decedent's driver's license (if any) should be returned to the Department of Motor Vehicles. The appointed fiduciary should obtain a tax identification number for the estate and open a checking account in the name of the estate to receive the proceeds of any accounts in the decedent's name. This account can be used to pay valid debts of the decedent and the ongoing expenses of the estate administration. And this is just a brief sampling of all the administrative tasks typically required.

- **Impact of the New Jersey Inheritance Tax:** One of the most important items to remember is that the New Jersey inheritance tax (which is levied on transfers to individuals other than lineal ancestors and descendants) has not been repealed. If any beneficiary of the will is a charity or an individual other than a lineal ancestor or descendant, or if any trusts are to be set up under the will (regardless of who the beneficiaries of such trusts may be), a New Jersey inheritance tax return must be prepared and filed (although no inheritance tax will be owed with respect to charitable bequests). If you or a loved one is seeking to leave assets to charities or individuals other than a lineal ancestor or descendant, one option to avoid having to file an inheritance tax return may be to name them as the beneficiary of all or a portion of a life insurance policy. In certain cases, this may help to save the time and trouble of preparing an inheritance tax return.

- **Inheritance Tax Waivers for Real Property:** Upon death, New Jersey places an inheritance tax lien on all of the decedent's real property. That lien remains until a tax "waiver" from the New Jersey Division of Taxation is received and filed with the county where the real estate is located. Waivers can only be obtained by filing an inheritance tax return (Form IT-R) or a slightly abbreviated form (L-9) if all estate beneficiaries are exempt from inheritance tax and no trusts are created under the decedent's will (if any). The failure to obtain these waivers (and the subsequent failure to file them with the appropriate county) will cause the estate's real property to essentially be nontransferable.

- **Inheritance Tax Waivers for Bank Accounts:** Upon death, even if no inheritance tax return is required, financial institutions will typically freeze accounts pending the receipt of another waiver specific to bank and brokerage accounts called an "L-8". The forms are self-executing (meaning, they need not be submitted to the Division of Taxation), and it's important for fiduciaries to fill the forms out correctly in order to get these accounts released.

- **Federal Estate Tax:** A federal estate tax return must be filed for any estate with assets in excess of the federal gift and estate tax exemption ($11.18 million for 2018). In addition, for surviving spouses, it is generally advisable to file a return for "portability" – which is the ability of the first spouse to die to pass to the surviving spouse any of his or her unused federal exemption. This "portability" election must be made on a timely filed estate tax return (due nine months after date of death, unless extended).

- **Income Tax Matters/Tax Basis Adjustments:** The appointed estate representative should arrange to have final income tax returns prepared for the decedent. In addition, a separate income tax return may be required for the estate (which is a separate taxable entity). Further, note that as a general rule, the income tax basis of the decedent's assets is adjusted to fair market value as of the date of death. Executors may consider recording the adjusted income tax basis of non-cash assets distributed to beneficiaries to enable the beneficiaries to properly report gains on inherited assets going forward. Additionally, when the decedent owned an interest in a partnership or limited liability company at date of death, in certain cases partnership tax elections may be made to adjust the tax basis (for depreciation or otherwise) of partnership property with respect to the estate's partnership interest passing to beneficiaries.

- **Disclaimers:** Once the estate's beneficiaries have been identified, it is always a good idea to consider whether any beneficiary should "disclaim" (i.e., refuse to accept) his or her inheritance. For example, if a child whose estate already exceeds the federal exemption amount (presently, $11.18 million) stands to inherit $500,000 from a deceased parent, he or she may prefer to simply disclaim his or her interest in such a bequest, which allows the disclaimed assets to pass to the next beneficiary in line (often, the disclaimant's own children) free of gift tax. A disclaimer requires the filing of documents with the surrogate's court where the fiduciary was appointed and (to take advantage of these favorable transfer tax rules) must be completed within nine months from the date of the decedent's death.

- **Insurance Policies, Retirement Accounts and other "Non-Probate" assets:** These assets typically will not pass in accordance with a decedent's will or as a part of an intestate estate if a proper beneficiary designation was filled out by the decedent during his or her life. Institutions holding any assets passing pursuant to a validly executed beneficiary designation must be separately informed of the decedent's passing, so that they can provide the necessary paperwork to the appropriate parties who can claim their respective shares of any insurance policies, retirement accounts, etc. It is advisable for disclaimers to also be considered with respect to these types of assets, where appropriate.

- **Commissions:** Fiduciaries are entitled to statutory commissions for undertaking these important fiduciary duties. If a fiduciary desires to receive commissions, it is important that they be calculated correctly in accordance with the relevant statutes to avoid disputes with beneficiaries.

- **Refunding Bonds/Releases/Waivers of Accounts:** The purpose of these documents (which are often combined into one agreement) is two-fold. Beneficiaries who sign these documents (when properly drafted) agree to (1) repay any amounts they receive from a fiduciary in the event of a later discovered liability of the estate (e.g., a tax return audited prior to the close of the statute of limitations, or a disputed liability that is determined to be valid after distributions have occurred); and (2) release the fiduciaries from any liability from their actions taken to faithfully administer the estate and distribute the proceeds to the appropriate beneficiaries. Executors should consider what financial disclosures with respect to the administration of the estate will be circulated to beneficiaries as part of getting a sign-off. Refunding bonds are required, by statute, to be filed with the court of the county where the fiduciary is appointed. Releases and Waivers of Account protect the fiduciary from a beneficiary who later takes issue with any of the fiduciary's acts undertaken in due course of the administration of an estate. Having beneficiaries sign these documents provides needed certainty for fiduciaries who want to ensure that beneficiaries may not pursue claims against them in the future after final distributions have been made and an estate has been closed.

As noted, the foregoing is just a small sample of the various steps involved with a full administration of an estate. We encourage anyone who has been asked to serve as an executor or wishes to qualify as administrator to speak to counsel about their responsibilities, duties, and their rights – regardless of how small or large the estate may be.

STAY TUNED…

On July 17, 2018, New Jersey, along with New York, Connecticut and Maryland, filed a lawsuit against the federal government to void the new $10,000 cap on the federal income tax deduction for state and local taxes. It will likely take some time to resolve this matter in the courts, but if it meets with any success, it will be discussed in a future Update.

As Sherman Wells continues to expand, we would like to warmly welcome three new members to the Tax and Trusts & Estates Group:

Jane L. Brody, Partner

Jane advises clients in the areas of estate planning, estate administration, family and business succession planning, business counseling including planning for closely held businesses and their owners, general business law and commercial law, and she represents banks and borrowers in the closing of commercial loans and commercial real estate loans.

Prior to joining Sherman Wells, Jane was a partner with Saiber LLC and a founding partner of Marcus, Brody, Ford & Kessler, L.L.C.

Michele A. Fiorentino, Associate

Michele has assisted clients on a broad range of tax matters, including mergers, acquisitions, dispositions, reorganizations and internal restructurings. Michele also has significant experience in tax planning, transaction structuring and executive compensation.

Prior to joining Sherman Wells, Michele was a senior associate in the Mergers and Acquisition Tax group of KPMG, LLP. She also previously was an associate in the Tax Department of Weil, Gotshal & Manges, LLP.

Cindy Scibilia, Paralegal

Cindy has more than 30 years of experience in estate planning and estate and trust administration. Cindy assists the attorneys in the drafting of wills, trust agreements, powers of attorney, and living wills. With respect to estate administration, Cindy is involved in all aspects of the administration of estates, including the probate proceeding, marshalling and valuing assets, assisting with the preparation of federal and state estate and inheritance tax returns, and assisting with federal and state estate tax audits.

Prior to joining Sherman Wells, Cindy was a paralegal with Saiber LLC and Marcus, Brody, Ford & Kessler, L.L.C.

Welcome to the Sherman Wells team, Jane, Michele, and Cindy.

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