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Tax Tips for the Professional Advisor

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PLANNING CONSIDERATIONS UNDER THE NEW STATE OF WASHINGTON ESTATE TAX:

by David B. Sweeney

"The more things change, the more they remain the same." Alphonse Karr

In response to the Washington Supreme Court's February 2005 effective repeal of the Washington estate tax in the Hemphill case, the Washington State Legislature enacted a new "stand-alone" Washington estate tax effective for decedents who die May 17, 2005 and later. The exemptions are $1,500,000 for decedents who die this year and $2,000,000 for decedents who die in 2006 and later. Although the new law incorporates some provisions of the Internal Revenue Code as of January 1, 2005, the new tax remains in effect whether or not Congress repeals the federal estate tax.

The tax rates for the new State of Washington estate tax start at 10% for amounts over $1,500,000, and go up to 19% for amounts over $9,000,000, but the Washington tax paid is a deduction from the federal gross estate in determining the federal tax. If the federal tax is a flat 46% (next year), then the effective State tax would be from about 5.4% to 10.2%.

The tax is based on the federal taxable estate less the applicable exemption, so the various deductions allowed for federal purposes, including the marital deduction, will be available for state purposes. A state return must be filed whenever a federal return must be filed, whether or not a state tax is owing.

Elections and valuations made on the Washington return must be consistent with elections and valuations made on the federal estate tax return, except that a different QTIP election may be made on the state return than on the federal return.

The new law allows a deduction for the value of qualified real property and qualified tangible personal property used for farming purposes (including timberland).

On September 13, 2005, the Department of Revenue issued preliminary discussion drafts of proposed rule changes made necessary by the adoption of the new estate tax.

Tax-related formula provisions in planning documents should be reviewed to reflect the potential for a disparity between the federal and state exemptions.

The State of Washington has no gift tax. In the current situation this would have to be considered a defect in the state tax structure. This creates a loophole, just as would be if there were a federal estate tax but no federal gift tax.

In looking just at the State of Washington estate taxes, and disregarding any other taxes, there will always be a savings if the decedent makes a gift, whether it is a so-called deathbed gift or otherwise, because it will lower or eliminate the State of Washington estate tax. For instance, if someone has a $4,000,000 estate and makes a gift this year to bring the value below $1,500,000, and then dies this year, there would be no State of Washington estate tax, for a savings of about $170,000.

There would of course be a federal gift tax, and does it make sense to pay a gift tax in an

era of possible repeal of the federal estate and gift tax? The donee would not receive a new cost basis as he would if there had been an inheritance instead of a gift, so the capital gains tax would have to be considered and weighed against the absence of the state estate tax. For decedents with high-basis assets, a gift of some amount (possibly just up to the amount that would require payment of a federal gift tax) may make sense.

For ill or elderly individuals, a gift can be made by someone else using a power of attorney, if the language in the power of attorney authorizing gifts is broad enough. The language authorizing gifts should say to whom the gifts may be made and for what purpose. If gifts could be made to reduce federal or state estate taxes the language is probably broad enough. If the language is limited to annual exclusion amounts or consistent with previous gifting activity, the language may not be broad enough.

In 2005 the federal estate tax rates go from 45% to 47%, but starting in January, the federal estate tax rate is a flat 46%. For the three years after next year the federal rate is a flat 45%. So for the first time the federal rate will be one flat rate. The generation-skipping tax rate will be at the maximum federal rate, or starting next year, a flat 46%. If you add the State of Washington tax to the federal tax, the estate tax rate for the first time, combining federal and state, will be greater than the generation-skipping tax rate. The State of Washington generation-skipping transfer tax was repealed effective May 17, 2005. If a taxable termination or distribution is the result of a death that occurred on or after May 17, 2005, there is no Washington GST tax.

For trusts which skip generations, it has been common to divide the trusts into two trusts, one which is exempt from generation-skipping taxes and one which is not. It has been common in the trust which is not exempt to give the beneficiary a general power of appointment, to make the trust taxable for estate tax purposes instead of for generation-skipping tax purposes. This is because in the past, the generation-skipping tax was at the maximum federal estate tax rate, and this was done in order to reduce the tax rate. However, when this is done now, the combined federal and state estate tax rate will be greater than the generation-skipping tax rate, so giving this general power of appointment will increase the overall taxes and not decrease them.

Presumably this problem could be solved by the beneficiary disclaiming the general power of appointment if the beneficiary can do that within 9 months of when the decedent died, but a better solution would be to revise the document to cut the power back to a broad form of limited or special power of attorney.

Finally, the State of Washington estate tax may be significant enough now so that if an elderly person has a home in a state other than Washington which is used for part-time purposes, that other state could be looked at to see whether it has a state estate tax, and if it does not, it may be possible to spend more time in the other state or change voting or driving records or in other ways to cause the individual to be domiciled in the other state, in order to avoid State of Washington estate taxes, at least to the extent that no real estate is owned in the State of Washington. State income and other taxes should also be considered.

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