Price & Farrington's Estate and Tax Planning *Fast* Faxts

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Estate, Tax and Wealth Planning for Advisors and Clients

Price & Farrington
Attorneys and Counselors at Law
12501 Bel-Red Road, Suite 215
Bellevue, Washington 98005
425-451-3583
Email: pricefarr@aol.com

Gotcha! Estate Taxes are Alive and Well in Washington State

D*id you know that Washington residents who die with taxable estates above $700,000 have to pay a Washington state estate tax even though no tax is owed to the federal government?*

If you kick the bucket (technical legal term) in 2002 or 2003 with a taxable estate of $1 million, you (or technically, your estate, since you're no longer around to experience the bad news), will owe zero federal estate tax but your survivors will write Olympia a check for $33,200 for Washington state estate tax. And the check will be even larger if your net taxable estate is worth more.

A little pick-me-up. Few people realize that Washington state (and many others) has for years imposed a transfer tax on decedents' estates. The tax has been equal to the full credit the federal government offers to states that collect their estate taxes based on the state death tax credit allowed against the federal estate tax. These types of taxes are known as "pick-up" taxes because they allow a state to "pick up" (i.e., collect) the federal credit. In effect, the federal *and* state estate taxes equal what the federal tax would be if there were no state transfer tax. The taxpayer pays no additional tax by reason of the state estate "pick-up" tax; the state simply takes a share of the total tax that would have gone to the feds. If, for example, an estate owes $20,000 in Washington estate tax, it will receive a credit toward any federal estate tax that is due. That means that while two checks will have to be written, the state's share will come from the total that would have been due the feds, so the decedent isn't "out" any additional dollars.

But that is no longer the case. In 2001, Congress, in addition to repealing the estate tax in 2010, also phased out the state death tax credit, reducing it by 25 % in 2002, 50% in 2003, 75% in 2004 and completely by 2005. Beginning in 2005 state death tax will not be a credit but instead will be deductible against the federal estate tax.

Decoupling. Since the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001, lawmakers across the country have failed to bring state estate tax laws in compliance with the new federal law. The taxes have become "decoupled", leading to a state tax now being imposed on estates too small to be subject to federal tax. Eleven states have actually passed decoupling legislation. In five other states, including Washington, the laws have been effectively decoupled. The legislators in Olympia haven't taken action to change the law which ties the amount of the state "pickup" (or "sponge") tax to the 1997 Taxpayer Relief Act. As a result, unless the legislature acts, heirs of folks dying in Washington will be subject to paying state estate tax for estates over $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005 and $1 million in 2006 and beyond. With the current severe state budget crisis, exactly how likely do you think it is that your elected representatives in Olympia will pass legislation which results in losing the revenue that will be generated by the state estate tax? A very low percentage probability comes to mind.

Washington state voters made it clear that they don't want a separate state estate tax by passing Initiative 402 in 1981. Voters abolished the state's former inheritance tax by retaining the right to receive the "state death tax credit" for any amount paid in federal estate taxes. Because Washington state still follows prior federal law, an estate in Washington will still have to pay 100 percent of the state death tax credit amount that would have been allowed by law before 2002. That means that unless the Legislature acts, Washington residents will actually see their estate tax increase as a result of the federal change.

Impact. While this concern might seem to affect few Washingtonians, the reality is that many middle-income residents currently fall into this category. Add up the value of a home (median

"Lookin' good, Frosty!"

Quotables

"If your ship doesn't come in, swim out to it."
-Jonathan Winters

"Middle age is the awkward period when Father Time starts catching up with Mother Nature."
-Harold Coffin

"It is a good thing for an uneducated man to read books of quotations."
-Winston Churchill

"Pay peanuts and you get monkeys."
-Anonymous

"Imagination is more important than knowledge."
-Albert Einstein

"You cannot shake hands with a clenched fist."
-Indira Gandhi

"The naked truth is always better than the best-dressed lie."
-Ann Landers

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value in King County is $265,000), a brokerage account, life insurance policies equal to 8-10 times a person's annual income, and any retirement funds, and an estate could easily exceed $700,000. And here's something else to chew on: the change in the law means that overnight the Washington state estate tax return has metastasized from 2 pages to 38 pages! It now rivals in length the long-time bane of tax preparers: the Form 706 federal estate tax return.

Consider this possibility: If other states comply with the federal estate tax laws, high net-worth Washington residents might decide to move to one of those states, taking with them the spending power and corporate ties these residents could contribute to the state in the future.

Currently this inaction means: Washington residents with taxable estates of $700,000 to $1 million will have to pay state estate tax even though no tax is owed to the federal government. In 2002 a Washington resident with a taxable estate of $1 million will owe zero federal estate tax, but will pay $33,200 in estate tax to Olympia.

Many married couples' wills drafted before 2001 might need to be changed to reflect the new laws in order to protect their owners' estates. If a will includes a formula gift provision to protect assets willed to a spouse, it will have to be changed to take into account the discrepancy between the federal and state laws.

The use if a credit shelter (bypass) trust comes unraveled under the new laws. Existing formulas for funding the credit shelter trust on the first spouse's death will result in an unexpected estate tax on the death of that spouse.

Example. Assume the typical will or living trust of a Washington resident contains a common formula which places the full current federal estate tax "applicable exclusion amount" into a credit shelter trust. On the first spouse's death in 2002 or 2003, $1 million will pass into the trust. But under Washington's decoupling, the estate will be required to pay a Washington state estate tax of $33,200. To avoid this result in future cases, the attorney can draft wills and revocable trusts so that only $700,000 passes to the bypass trust. While no tax will be triggered on the first death, that strategy is likely to increase the amount of the federal estate tax due on the second spouse's death. In other words, limiting the funding to $700,000 results in wasting the balance of the available federal exclusion amount ($1 million) and pumping up the taxable value of the surviving spouse's estate.

This example illustrates the newest dilemma facing drafters of will and trusts in states that have "decoupled": whether to fully fund the credit shelter trust in order to minimize overall federal estate tax or to limit the size of the credit trust to the amount that avoids state estate tax on the first death. There is no correct or easy answer. Whether the overall tax burden will be less when the trust is fully funded with the federal exclusion amount or when funding is limited to the lower state estate tax exclusion will depend on factors such as: the rate of growth (or shrinkage) of asset values; the longevity of the surviving spouse; and the future of the federal estate tax.

Strategies. In the face of this uncertainty, be sure the estate planning attorney you are working with uses a strategy that preserves flexibility and allows the level of funding to be determined at the first spouse's death, rather than be set in stone beforehand.

Disclaim it. As the federal estate tax exclusion amount has risen in recent years, estate planning attorneys have increasingly avoided the use of a rigid formula. The properly drafted will or living trust allows the credit shelter trust to be funded by means of a *disclaimer* exercised by the surviving spouse. This leaves it to the surviving spouse to determine how much – if anything – the spouse should "give up" so that it passes to the credit shelter trust.

Q-Tip it. Another approach is to use a so-called QTIP (qualified terminable interest property) trust to provide flexibility. A competent attorney can draft the credit shelter trust so that it potentially qualifies as a QTIP trust. That way, if the full amount of the federal exclusion amount (currently $1 million) passes to the credit shelter trust, the executor or trustee can elect to qualify part of the trust (the difference between the federal exclusion and the state exclusion) for the marital deduction in order to avoid Washington state estate tax on the first death. As with the disclaimer-based plan there's a tradeoff between state death tax savings and potentially higher federal estate tax on the second spouse's estate. That is because the "cost" of the QTIP election in the first spouse's estate is the inclusion of the QTIP assets in the survivor's estate under code section 2044, potentially increasing the size of the federal estate tax on the second spouse's estate.

If state lawmakers in the future pass a law consistent with federal law, the question remains whether it will be retroactive. To avoid confusion and protect themselves, people should have their wills reviewed by a qualified estate planning attorney to make sure they are doing everything necessary to comply with both state and federal laws.

Conclusion. This is a good time to review estate plans to make sure they are up to date, drafted correctly and reflect personal values. One way to reduce estate taxes is to make charitable gifts. People should review their estate plans to determine whether all of their gifts are up to date, including gifts to nonprofit organizations. Bottom line—current estate tax law is confusing for state residents and could lead to legal headaches for the unaware.

Please don't hesitate to contact us if there is anything we can do to assist you or your clients in planning more effectively.

Glenn D. Price

"Who hired him?"

On behalf of the attorneys and staff at Price & Farrington we wish you – our colleagues, clients and friends – a happy holiday season and a rewarding, fulfilling 2003.