

CHAPTER 5



TAXES AND ESTATE PLANNING

Introduction

Estate taxes and other taxes imposed at the time of death have been an integral part of our federal tax system for more than ninety years. Many states impose some form of estate or inheritance tax as well. Although at the time of this writing there is a significant effort in some political circles towards the elimination of estate taxes, the continued imposition of some form of estate tax seems likely for the foreseeable future.

The federal estate tax is a transfer tax. A person's power to transfer assets at death is the underlying principle of estate tax. Therefore, the type of asset or how it is owned will not avoid the application of estate tax. It is an incorrect assumption by many people that avoiding probate is the same as avoiding estate tax. Many people establish living trusts (discussed in Chapter 4) or add the names of other people to their assets with the belief that this will avoid estate tax. Although these strategies may reduce the expenses of administering a person's estate (such as avoiding the probate process), only a coordinated and oftentimes complex approach will reduce or eliminate a person's estate tax liability at death.

Since the estate tax is a transfer tax, any asset subject to the decedent's control of disposition at death is subject to estate tax. For example, the decedent's banking and other financial accounts, stocks and bonds, annuities, real estate and other interests in real property are subject to estate tax. In addition, the benefits available under a life insurance policy as well as retirement plan benefits and individual retirement accounts are subject to estate tax (except under some limited circumstances). However, there are many strategies available to reduce or eliminate the application of estate tax to your estate.

The following discussion is not intended to be comprehensive. The provisions of the tax code pertaining to gifts and estates are very complicated. You should carefully review your assets and their values on a periodic basis, and contact your estate planning attorney if you have any questions regarding the application of taxes in your situation.

What is included in my estate for estate tax purposes?

As previously mentioned, the estate tax is a transfer tax. Thus every asset over which a person may control the distribution at death will be subject to estate

tax. This is what is referred to in the tax law as the “gross estate.” The following is a list of the assets that are often found in a person’s estate and subject to estate tax.

1. **Assets in the name of the decedent.** These assets include real estate, cash, stocks and bonds, retirement benefits (such as qualified retirement plans and individual retirement accounts), bank and other accounts held in financial institutions, personal property (such as household furniture and furnishings, motor vehicles, collections, artwork, etc.).
2. **Assets held in the name of the decedent with another person.** These assets are the same as those in item 1 above but are held in the name of another person along with the decedent. This is referred to as “joint tenancy.” If the joint tenancy is with the decedent’s spouse, for estate tax purposes the asset is deemed to be held equally between husband and wife. If the decedent owned the asset with a non-spouse, the entire asset is subject to estate tax unless the surviving joint owner(s) contributed funds (or other assets) at the time the asset was acquired.
3. **Life insurance.** The death benefit paid on a life insurance policy will be included in the decedent’s gross estate if the decedent possessed any incidents of ownership at death. Incidents of ownership include the power to change the death beneficiary of the policy, borrow from the policy and exercise other powers over the insurance policy as set forth in the tax law.

Furthermore, if an insurance policy is given away during lifetime and the insured dies within three years of the gift, the insurance proceeds will nonetheless be included in the decedent-insured’s estate. There can also be adverse income tax consequences if an insurance policy is sold to certain other persons or entities.

4. **Annuities.** Annuities (such as tax-deferred annuities) are also included in the gross estate for tax purposes. As with life insurance and retirement benefits, the annuity proceeds will be paid in accordance with the beneficiary designation. However, this designation will not affect the taxability of the annuity in the decedent’s estate.

It should also be noted that annuities, like retirement plan benefits, will likely have untaxed income inherent in the policy at the time of the owner’s death. This is income that was not taxed to the annuity owner during his or her lifetime (referred to in the tax law as “income in respect of a decedent” or “IRD”). Therefore, the annuity will be subject to estate tax as well as income tax to the beneficiary. A beneficiary of an annuity subject to estate tax may take a deduction on his or her personal income tax return for the estate tax that was paid on IRD to mitigate the effect of this “double taxation.”

5. **Assets controlled by the decedent.** Even though certain assets may not be owned by the decedent, they may still be included in his/her estate. For example, if the decedent establishes a revocable living trust and transfers her assets into the trust, she no longer owns the assets in a strict legal sense. However, her ability to access the assets under the terms of the trust and receive benefits from the trust, as well as her right to revoke or amend the trust, will result in the inclusion of the trust assets in her estate for estate tax purposes.

In addition, holding a power of appointment over assets may result in the inclusion of the assets in the decedent's gross estate even though he or she was not the owner of the assets.

6. **Assets with retained interests.** If a person transfers assets during his or her life, but then continues to use, enjoy, or derive benefit from those same assets (called assets with retained interests), then the value of the assets will be included in the taxable estate.

The marital deduction

As a general rule, any assets distributed to the decedent's surviving spouse will be exempt from estate tax. The decedent's gross estate will be reduced dollar for dollar by any amount distributed outright to the surviving spouse. In addition distributions to a trust for the benefit of the surviving spouse may qualify for the marital deduction, as will certain life estates.

Of course, assets distributed to the surviving spouse (or to a trust qualifying for the marital deduction) are subject to estate tax at the time of the surviving spouse's death. For this reason, the marital deduction only defers the payment of the estate tax on assets distributed to a surviving spouse, but does not eliminate it (unless the applicable exclusion—discussed below—is greater than the value of the surviving spouse's estate).

The marital deduction is not available for a surviving spouse who is not a citizen of the United States. Legal residency is not sufficient; the surviving spouse must be a citizen to qualify for the marital deduction. However, certain steps can be taken to secure the marital deduction for the benefit of a non-citizen surviving spouse.



The charitable deduction

The estate is entitled to a deduction for all amounts distributable to or for the benefit of a qualified charitable organization. As with the marital deduction, the charitable deduction will result in a dollar-for-dollar reduction of the gross estate subject to estate tax.

The IRS publishes a list of all of the organizations for which the charitable deduction is available. Certain other entities, such as governmental bodies and community foundations, will also qualify.

The applicable credit

Other than the marital deduction, the applicable credit or applicable exclusion amount may be the most important provision of the federal tax law available to a decedent's estate. This credit is often referred to as the "estate tax exemption amount" but it is really a credit, not an exemption. *For 2006, 2007 and 2008* the applicable credit is \$780,800. This credit equates to an exemption amount of \$2 million. Thus, in most circumstances, an estate of less than \$2 million will not pay any estate tax.

FOR EXAMPLE, ASSUME THAT THE DECEDENT'S GROSS ESTATE AFTER TAKING ALL ALLOWABLE DEDUCTIONS (THE "ADJUSTED GROSS ESTATE") IS \$800,000. THE APPLICATION OF THE ESTATE TAX RATES TO THIS ESTATE WILL RESULT IN A FEDERAL ESTATE TAX PAYABLE OF \$267,800. HOWEVER, NO ESTATE TAX WILL BE PAID BECAUSE THE APPLICABLE CREDIT OF \$780,800 WILL FULLY OFFSET THE TAX OTHERWISE PAYABLE.

Other deductions and credits

Numerous other deductions and credits are allowable in the computation of estate tax. For example, funeral expenses, professional fees incurred in the administration of the estate (such as attorney and accountant fees), and the executor's fees and costs are generally deductible. In addition, the debts of the decedent are deductible. A deduction is also allowed for any estate taxes paid to a state (discussed in further detail below).

Estate tax rates

Once the gross estate is determined and appropriate deductions are subtracted, the Internal Revenue Code applies a tax on the remaining estate. Currently the estate tax rate is 45% on the portion of a person's estate that exceeds \$2 million.

As discussed in Appendix 2, the applicable exclusion amount will increase to \$3.5 million in 2009, and for 2010, estate taxes will be repealed. However, the provisions of the Economic Growth and Tax Relief and Reconciliation Act of 2001 will sunset on December 31, 2010, with the result that prior law, along with its estate tax rates and exemptions, will once again be in effect.

State death taxes

As previously indicated, each state may impose a separate estate tax as well. This may be in conjunction with the federal estate tax or as a completely separate taxing process. Many states (including Oregon) impose a tax that is equal to a credit formerly allowed under the federal tax law known as the "state death tax credit." The allowance of the credit for federal tax purposes has been significantly modified in recent years, although Oregon applies these tax rules as though the modifications had not been enacted.

It is important to note that although Oregon has elected to impose a tax equal to the state death tax credit once allowed under federal tax law, this does not mean that the credits and deductions allowed for federal tax purposes are necessarily the same for Oregon state tax purposes. For example, the federal applicable credit described above has the effect of sheltering estates of up to \$2 million from federal estate tax. At the present time, \$1 million may be sheltered under Oregon law. Thus, a \$2 million estate will pay no federal estate tax but will nonetheless pay estate tax to the state of Oregon.

Washington has adopted a "stand-alone" estate tax that is not tied to the federal tax law. Washington also allows a deduction for estates of up to \$2 million. In addition, there is also an unlimited exemption for qualified farm property. Washington's estate tax system uses a graduated rate structure of up to 19% that applies to estates exceeding \$9 million.

Both Washington and Oregon will allow a deduction for transfers that qualify for the marital or charitable deduction as described above.

Other "death" taxes

It is important to remember that, in addition to estate taxes, your assets may be subject to certain income taxes as well. For example, your beneficiaries will still have to pay any income tax owed on your retirement plans and individual retirement accounts when they receive distributions. Other examples include the

deferred gain on tax-deferred annuities, deferred compensation under employment agreements, and other contract rights (such as a seller's interest in a real estate contract or land sale contract). Certain steps can often be taken to reduce these income taxes.

Gift taxes

The purpose of the gift tax provisions of the Internal Revenue Code is to impose a tax on the transfer of assets during a person's lifetime that would have been subject to estate tax at death had the assets not been gifted. The gift tax provisions of the tax law are substantially similar to the estate tax provisions, although many of these provisions have been substantially modified since 2001 by the Act (see Appendix 2).

The gift tax law includes largely the same provisions regarding transfers to spouses and charities as are in effect for estate tax. Certain exemptions are available for gifts to non-citizen spouses. Gifts to qualified charitable organizations are gift-tax free but are subject to certain limitations for purposes of determining the income tax charitable deduction that is available to the donor.

The applicable credit amount discussed above is also available to the donor of a gift but limited to \$1 million. Thus, a gift of up to \$1 million may be made without the imposition of a gift tax. Use of this credit during lifetime reduces the amount of the credit available to the donor's estate at death. However, the credit is frequently used to transfer appreciating assets to children and others during lifetime since this will have the effect of reducing the overall tax (gift and estate) payable at the donor's death. Strategies are also available to reduce the value of an asset for gift tax purposes (discussed in Chapter 6), thus making better use of the donor's applicable credit amount.

There are several additional opportunities with regard to gifting that are not available to estates. One of the most important is the annual gift tax exclusion. These gifts are not subject to gift tax and, in general, do not need to be reported to the IRS. For many years prior to 1997, the annual exclusion amount was \$10,000 per donee per year. Since 1997, this amount has been tied to inflation and now stands at \$12,000. Annual exclusion gifts may be made to an unlimited number of persons each year. Thus, a married couple with three children may make gifts totaling \$72,000 per year to their children. Annual exclusion gifts may be made outright to the donee, to a custodial account (known as a Uniform Transfers to Minors Act account), a 529 plan, or to certain qualifying trusts for the benefit of a donee.

In addition to the annual gift tax exclusion, other transfers, such as transfers for payment of uninsured medical expenses and for payment of tuition and related expenses, are not subject to gift tax. However, you must be very careful in how these transfers are made to be sure that you fall within the narrow exceptions that apply.

Generation skipping transfer tax

The generation skipping transfer tax (GSTT) was enacted to prevent large, untaxed transfers to individuals who are two or more generations below that of the donor (referred to in the tax law as “skip persons”). In theory, a donor whose children are already wealthy may avoid having his assets subject to estate tax again in his children’s estates by giving certain assets or his entire estate to his grandchildren, thereby skipping a generation. The GSTT was implemented in order to collect the tax dollars that would have been generated if the assets were taxed at each generational level.



The GSTT applies to both gifts as well as transfers to skip persons on death. Certain transfers to skip persons will qualify for the annual gift tax exclusion treatment discussed above. In addition, there is a separate GSTT exclusion for transfers to skip persons. The GSTT exemption is currently \$2 million. Proper use of this exclusion can be important in estate planning where a substantial portion of the estate will *or could* be transferred to skip persons (such as grandchildren).

The GSTT tax rate is the highest marginal estate tax rate. Until recently, this was 55%; however, with the enactment of the 2001 Tax Act, this rate has been reduced. Beginning in 2007, the rate is 45%. See Appendix 2.

The GSTT can be a trap for the unwary. For example, if you transfer assets to a trust for the benefit of children (either during lifetime or at the time of your death) and a child dies prior to the termination of the trust, GSTT may apply if the deceased child’s share of the estate will be distributed to his or her own children (the donor’s grandchildren). Certain steps can be taken to mitigate the consequences of this transfer.

Conclusion

Understanding the impact of taxes on your estate is an important part of effective estate planning. Even in estates that are not large enough to pay estate tax, there may nonetheless be significant income taxes due at death without proper planning.