

## **17. A Cost of Dying: Estate Taxes**

The 2001 Tax Act significantly decreases the estate tax for years 2002 through 2009 and repeals it completely in 2010. However, the Act has no effect beyond the year 2010, unless Congress acts to extend it. The decreases and repeal, plus the possibility that both are temporary, complicate estate planning because of the uncertainty as to what the estate tax rules will be when you die. It is important to consult your tax advisor before making changes to your existing estate plan. You may want to review your estate plan with your advisor to determine whether your existing plan provides enough flexibility to maximize the advantages of the changes in the law while still providing the desired benefits to your beneficiaries.

Few people realize how high the cost of dying can be. This cost comes primarily from the federal government's tax on the transfer of property at death: the federal estate tax. Under most circumstances, the first \$1,000,000 (in 2003) of your net estate is exempt from the estate tax. If you died in 2003 with a taxable estate of \$1,100,000, an estate tax of \$41,000 would have to be paid by your estate. As this example illustrates, the amount of your net worth over \$1,000,000 will generally be taxed at a beginning rate of 41%. The maximum estate tax rate in 2003 is 49%. Proper estate planning can help you to minimize - or even eliminate - this tax cost on your death.

### **The Importance of Estate Planning**

Estate planning is often misunderstood. You can define it as planning for the transfer of assets to your beneficiaries, either before or after death, in accordance with your wishes, while minimizing the taxes and other costs associated with the transfer. Usually, your wishes are expressed in your Will, which is the cornerstone of your estate plan.

You already have an estate plan, even if you have done nothing. If you do not have a Will, the state of Washington, by statute, mandates how your property will pass at your death. The potential problems with this arrangement are:

- Your assets may not pass according to your wishes.
- The federal government may be a major beneficiary of your estate.
- If any family members need special consideration or help, they probably will not get it.

The laws relating to both the federal estate tax and the Washington state estate tax provide ways to reduce taxes, Congress and the state legislature, however, will not do your estate planning for you. You are the only person who can do it.

### **Estate Planning: Start by Calculating Your Net Worth**

A good way to start your estate planning (and to start any kind of financial planning) is to calculate your net worth. Net worth is the total value of everything you own (your

assets) less all that you owe (your liabilities), See the sample net worth worksheet at the end of Chapter 2. Completing the worksheet periodically (annually for example) will give you a good idea of how large your estate is and whether it is growing or shrinking. This information will help you and your advisors in monitoring your planning over time.

In general, your net worth, when added to life insurance proceeds and retirement plan benefits payable as a result of your death, constitutes the gross amount of your property that will be subject to estate taxes at your death. From this amount, the federal estate tax law allows your estate to deduct your debts, funeral expenses, and the costs of administering your estate (e.g., attorneys', accountants and appraisers' fees). Your estate can also deduct amounts you leave to charity. Probably the most significant deduction is the

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unlimited deduction allowed for property you leave to or for the benefit of your spouse if you are married at death and if your spouse is a U.S. citizen. This deduction is commonly referred to as the "unlimited marital deduction."

## **Overview of Federal Estate and Gift Tax**

In 1976, 1981, 1997, and 2001, Congress passed legislation that significantly changed the prior federal estate and gift tax laws. The first piece of legislation, the Tax Reform Act of 1976 ("the 1976 Act"), significantly restructured the taxation of gifts and estate. It made gifts and estate subject to a "unified" transfer tax, so-called because the tax is based on aggregating transfers made both during a person's lifetime and upon his or her death.

The unified transfer tax is similar to the federal income tax in that you must determine the value of the gross amount transferred, then subtract allowable deductions, to determine the transfer subject to tax. The tax is imposed at graduated rates and is reduced by certain credits, including a credit of \$345,800 (in 2003) and a credit (until 1995) for state death taxes. As result of the 1976 Act (with adjustment in the 1981 Act), the credit now (in 2003) has the effect generally of exempting \$1,000,000 of your assets form the tax. Because of the credit, you have what is commonly referred to as the "estate and gift tax exemption." This exemption is especially important in planning smaller estates. the technical term for the exemption is now the "applicable exclusion amount" and the technical term for the credit is the "applicable credit amount." Prior to 1998, the credit was referred to as the unified credit.

The second major piece of legislation in this area, the Economic Recover Tax Act of 1981 ("the 1981 Act") also made several important changes in the unified transfer tax and the marital deduction available for property passing to a surviving spouse.

The Taxpayer Relief Act of 1997 increased the estate and gift tax applicable exclusion amount beginning in 1998. Beginning in 2002, the 2001 Tax Act decreases the top marginal transfer tax rate, *caps* the gift tax applicable exclusion at \$1,000,000, and increases the estate tax applicable exclusion amount. The table below summarizes the changes:

**In the case of gifts made, and estates of persons dying, during:**

	Applicable Exclusion Amount		Applicable Credit Amount		Maximum Transfer Tax Rate
	Gift Tax	Estate Tax	Gift Tax	Estate Tax	
1998	\$ 625,000.	\$ 625,000.	\$202,050.	\$ 202,050.	55 %
1999	\$ 650,000.	\$ 650,000.	\$211,300.	\$ 211,300.	55 %
2000 and 2001	\$ 675,000.	\$ 675,000.	\$220,550.	\$ 220,550.	55 %
2002	\$1,000,000.	\$1,000,000.	\$345,800.	\$ 345,800.	50 %
2003	\$1,000,000.	\$1,000,000.	\$345,800.	\$ 345,800.	49 %
2004	\$1,000,000.	\$1,500,000.	\$345,800.	\$ 555,800.	48 %
2005	\$1,000,000.	\$1,500,000.	\$345,800.	\$ 555,800.	47 %
2006	\$1,000,000.	\$2,000,000.	\$345,800.	\$ 780,800.	46 %
2007 and 2008	\$1,000,000.	\$2,000,000.	\$345,800.	\$ 780,800.	45 %
2009	\$1,000,000.	\$3,500,000.	\$345,800.	\$1,455,800.	45 %
2010	\$1,000,000.	N/A	\$345,800.	N/A	35 %
2011 *	\$1,000,000.	\$1,000,000.	\$345,800.	\$ 345,800.	55 %

\*Assuming that the provisions of the 2001 Tax Act are not extended after 2010.

**Decrease in Top Marginal Rates**

The 1981 Act provided for a gradual reduction in the top marginal rates from 70% to 50%. These reductions had the greatest impact on larger estates. The 2001 Act provides for further rate reductions beginning in 2002. For 2003, the maximum rate is 49% which applies to taxable estates in excess of \$2,000,000.

### **Unlimited Marital Deduction**

The 1981 Act introduced the unlimited marital deduction, and as a result, dramatically changed the manner in which property left to a surviving spouse is taxed. This change allows you to leave all of your assets (both community and separate property), to your surviving spouse entirely free of tax. The property will not necessarily avoid taxation altogether, however, because it is included in the surviving spouse's estate and will be subject to estate tax at his or her death.

Not all bequests to a surviving spouse qualify for the unlimited marital deduction. As long as your spouse is a U.S. citizen, property that does qualify includes:

- An outright bequest to a surviving spouse.
- A trust that gives the surviving spouse the right to receive the entire income from the trust, at least annually and that also gives the surviving spouse the right to determine who ultimately receives the trust assets after the spouse's death.
- Property that meets the requirements for "qualified terminable interest property" (often referred to as "QTIP").

Generally, the rules for a QTIP deduction require that the surviving spouse must receive all income from the property for his or her lifetime. Additionally, no person, including the spouse, can have the power to appoint any part of the property to any person other than the spouse during the spouse's life. Finally, an election which selects the property for the QTIP deduction must also be made. Usually, qualified terminable interest property will take the form of a trust (a QTIP trust), but it can apply to other forms of property ownership, such as legal life estate.

The QTIP provision is especially useful in a second marriage where the decedent may want to provide income for the surviving spouse during his or her lifetime but would like to make sure the trust property ultimately passes to the children of a prior marriage.

Transfer of property to a surviving spouse who is not a U.S. citizen may qualify for the unlimited marital deduction only if the property passes to a "qualified domestic trust." The basic requirements for such a trust are as follows

- The trust instrument must require at least one trustee to be a U.S. citizen;
- The surviving spouse must be entitled to receive all trust income;

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- The trust must meet IRS requirements assuring that any federal estate tax on the trust property at the surviving spouse's death will be collected; and

- The decedent's representative must irrevocably elect to have the trust qualify for the marital deduction.

### **Using the Marital Deduction (Without Overusing It)**

The potential family estate tax savings from using both spouses' estate tax applicable exclusion amounts are greatly enhanced by the 2001 Tax Act. However, use of the increased exclusion or the marital deduction in the estate of the first spouse to die must be considered in light of the nontax considerations discussed in this chapter in Estate Planning - Fifth Edition.

- The age and health of the surviving spouse.
  - The liquidity of both estates.
  - The financial needs of the surviving spouse.
  - The potential appreciation in the value of the assets between deaths.

Most married couples will plan to pay no estate tax on the estate of the first to die. For optimal tax results, the estate tax exemption (\$1,000,000 in 2003, increasing to \$3,500,000 by 2009) of the first spouse to die will be placed in trust (called a "credit shelter trust") for the lifetime benefit (income and principal) of the surviving spouse. At the surviving spouse's death, the trust's assets go to children, etc. This "uses" the first spouse's applicable exclusion amount. The assets in this trust will not be subject estate tax on the death of the surviving spouse. The balance of the estate the first to die will be sheltered from tax by using the unlimited marital deduction, in one of the forms discussed above. The advantage of such a plan is that funds otherwise payable in tax to the federal and state governments are made available to the surviving spouse for life, with tax ultimately being paid only after both spouses have passed away.

### **Washington State Estate Tax**

The 2001 Tax Act phases-out the federal credit by 2005, reducing the credit by 25% in each of the next four years. This change could have repealed the Washington State estate tax, because it is only intended to equal the federal credit. For the repeal to occur, however, the Washington Legislature would have to pass conforming legislation; otherwise, the Washington estate tax as of January 2001 will continue to be collected, even if there is no available federal credit (although a federal deduction will be available after 2004). As of 2003, the Washington legislature has not passed conforming legislation. What this means is that an estate that is exempt from federal estate tax because it is less than the federal applicable exclusion amount, may still be subject to Washington estate tax. You should contact a professional advisor for assistance in planning for the Washington estate tax.

### **The Importance of Reviewing Existing Planning**

It is now more important than ever to review existing Wills, trusts, and estate planning strategies to make sure that the current opportunities for saving taxes are fully utilized. A few examples will illustrate this point.

With the 2001 Tax Act's increasing estate tax applicable exclusion, these examples are less meaningful because they address specific tax savings from utilizing the estate tax exemptions of both spouses rather than maximizing the tax-free transfer of assets to the surviving spouse. As the estate tax applicable exclusion increase, there is greater likelihood in many families that the surviving spouse's exemption will be sufficient to eliminate the estate tax.

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**How Estate Planning Could Save \$258,500 of Tax**

Mr. and Mrs. Brown are Washington residents who have community property with a total value of \$1.3 million. Mr. Brown dies in 1999. His survivors are his wife and their two children.

**Situation 1: Mr. Brown Dies Without a Will. Total Tax Due for Mr. and Mrs. Brown: \$258,500**

If Mr. Brown dies without a Will, under Washington state intestacy law, Mrs. Brown would receive Mr. Brown's \$650,000 share of the community property as well as continuing to own her \$650,000 share.

No federal estate tax or state estate tax would be due on his death, calculated as follows:

Gross Estate: Mr. Brown's one-half of community property	\$ 650,000.
Less: Deductions	( assume 0.)
Unlimited marital deduction for property passing to surviving spouse	<u>( 650,000.)</u>
Taxable Estate	<u>\$ 0.</u>
Federal Estate Tax	<u>\$ 0.</u>

Upon Mrs. Brown's subsequent death, however, a total of \$258,500 in taxes would be payable, calculated as follows:

Gross Estate: Mrs. Brown's one-half of community property	\$ 650,000.
Property inherited from Mr. Brown	<u>650,000.</u>
	1,300,000.
Less: Deductions	<u>( assume 0.)</u>

Taxable Estate	<u>\$1,300,000.</u>
Federal Estate Tax	\$ 469,800.
Applicable Credit Amount	( 211,300.)
Total Death Taxes	<u>\$ 258,500.</u>

(The \$258,500 is comprised of \$206,900 in federal estate tax and \$51,600 in Washington state estate tax.)

**Situation 2: Mr. Brown Dies With a Will Leaving Everything Outright to Wife. Total Tax Due for Mr. and Mrs. Brown: \$258,500**

Merely preparing a Will is not enough to minimize death taxes. If Mr. Brown had died with a Will (or a community property agreement) that left everything to his wife, the total tax due after both deaths would also be \$258,500. The calculations are done in the same way as in Situation 1 above.

**Situation 3: Mr. Brown Dies With a Will Making Proper Use of the Estate and Gift Tax Exemption. Total Tax Due: -0-**

With proper estate planning, the \$258,500 in taxes could be avoided entirely if Mr. Brown dies with a Will taking proper advantage of the \$650,000 (1999) applicable exclusion amount. For example, his Will could give his one-half of the property (\$650,000) outright to

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the two children. Alternatively, as previously discussed, his Will could have created a credit shelter trust with his \$650,000. This trust may provide income to Mrs. Brown for her lifetime. Any remaining trust assets pass to the children upon her later death.

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The total tax due in this case calculated as follows:	
would be zero,	
Gross Estate: Mr. Brown's	
one-half of community property	\$ 650,000.
Less: Deductions	(assume 0.)
Taxable Estate	<u>\$ 650,000.</u>
Federal Estate Tax	\$ 211,300.
Applicable Credit Amount	( 211,300.)
Total Death Taxes	<u>\$ 0.</u>

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Mr. Brown's one-half passes directly to the credit shelter trust and is not subject to estate tax because of his \$650,000 exemption.

Then, upon Mrs. Brown's subsequent death, taxes have been eliminated, as follows:

Gross Estate: Mrs. Brown's one-half of community property	\$ 650,000.
Less: Deductions	(assume 0.)
Taxable Estate	<u>\$ 650,000.</u>
Federal Estate Tax	<u>\$ 211,300.</u>
Applicable Credit Amount	<u>( 211,300.)</u>
Total Death Taxes	<u><u>\$ 0.</u></u>

### **Generation-Skipping Transfer Tax**

A special "generation-skipping transfer tax" now applies to certain property transfers at death. See Chapter 18 on generation-skipping transfer tax.