

New estate tax established in May

By Dorothy K. Foster

The Washington Legislature established a new estate tax on May 17, 2005 and made it applicable to estate of people who die after that date.

The new estate tax (the "Estate and Transfer Tax Act") is now imposed in addition to the federal estate tax. It is a "stand-alone tax," in that even if the federal estate tax is repealed this tax will remain.

There is a great deal of confusion surrounding the estate tax in Washington.

You may have heard that, since 2001, the Washington Department of Revenue had levied an estate tax on Washington residents, even when their estates were not obligated to pay federal tax. On Feb. 3, 2005, the Washington Supreme Court declared this estate tax invalid.

As a result, the estates of people who died from 2001 through 2005 are receiving close to \$150 million in refunds from the state.

Washington's new estate tax is levied on property located in Washington state, regardless of where the former owner lived. Property "located in Washington" includes real estate, vehicles, jewelry and clothing.

Business and investment assets (such as stock, partnership interests, cash) are deemed to be located in Washington only if the decedent lived here at death.

What if the decedent had some property here and some elsewhere? The tax is reduced by the percentage of assets located out of state.

Not every estate is subject to the tax. In 2005, estates with assets (wherever located) of less than \$1.5 million need not file a Washington estate tax return and are exempt from tax.

In 2006, and thereafter this threshold is increased to \$2

million. An estate exceeding this threshold is required to file an estate tax return even if exempt by virtue of the marital deduction (the rule that one may pass any amount of property tax free to a surviving spouse) or the charitable deduction (the rule that one may pass any amount tax free to a charitable organization located anywhere in the world).

A surprising element of the tax is that an estate with Washington property under the threshold amount is subject to tax if out-of-state and Washington property combined exceed the threshold amount.

Any estate that exceeds the threshold is subject to tax. The measure of the tax is 10 percent on the first \$1 million in excess of the threshold and increases up to 19 percent on the excess greater than \$9 million.

Fortunately, if an estate also is required to pay federal estate tax, the amount of tax paid to the state of Washington is entirely deductible on the federal estate tax return.

What about the family farm or timberland? They are excluded from tax if they meet some very detailed requirements:

- The value of farm property or timberland (reduced by any debt against the property) must be at least 50 percent of the total estate.
- At least half of the farm property or timberland must be real estate.
- The other half must be equipment or other property used in farming or timber management.
- The decedent or a member of the decedent's family must have owned the property for five out of eight years prior to death and must have "materially participated" in farming or timber management.

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- The property must pass to a member of the decedent's family.

What can be done to avoid this tax? Even for those with no farm, timberland, surviving spouse or interest in charity, the estate planning tools traditionally used in federal estate tax planning apply equally to the Washington tax.

A loophole in the Washington tax, however, provides additional planning opportunities.

Unlike the federal estate tax (which applies to gifts exceeding \$11,000 per year), the Washington estate tax does not apply to gifts made during life.

This means that one may avoid Washington estate tax entirely by giving away, during one's lifetime, any amount in excess of the threshold amount.

Even though any Washington estate tax paid at death is deductible on the federal estate tax return, exclusion of property from the Washington estate tax base entirely provides a better tax result.

One must beware of federal gift tax in making deathbed gifts, however.

Federal gift tax is levied against gifts exceeding \$1 million during life. Any gifts made for the purpose of avoiding Washington estate tax may inadvertently incur federal gift tax.

Federal income/capital gains tax issues complicate things further. Careful analysis of tax consequences to the recipient must be made with respect to the gift of any particular asset.

The federal estate tax threshold is scheduled to increase to \$3.5 million in 2008. Some members of Congress hope to see it repealed. As our exposure to federal estate tax diminishes, our need to plan for Washington estate tax increases.

Proper coordination of the two estate tax schemes is necessary. Review your will (or revocable living trust) and call your estate planning adviser if you need help.

For details of the act, see the Department of Revenue's Web site: <http://dor.wa.gov>

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