

**ESTATE AND GIFT TAXES
(Federal, Washington, and Oregon)**

By Charles K. Toole

A. INTRODUCTION

The Good News!

As of the writing of this article (April 15, 2010), there is no federal estate tax for estates of decedents who die in 2010.

The Really Bad News!

Unless Congress acts to change the estate tax law before the end of 2010, the estate tax will go back into effect on January 1, 2011, with an estate tax exemption amount of \$1,000,000 (instead of the \$3,500,000 exemption in effect in 2009), and a top tax rate of 55% (instead of the top rate of 45% in effect in 2009). This means, of course, that you have to die in 2010 to take advantage of the one year repeal of the federal estate tax.

And it could get worse!

Many existing wills and trusts with formula provisions based on the federal estate tax and generation skipping transfer tax (GSTT) laws in effect before 2010, no longer make sense and are "estate plan disasters waiting to happen." This means, of course, that although dying in 2010 means no federal estate tax and no GSTT, the decedent's estate plan might turn out to be a complete mess if the decedent's will or trust utilizes these outdated formula provisions. As explained later in this article, the State of Washington has passed legislation to address this problem, but Oregon has not.

Section B of this article summarizes the federal estate tax that was in effect in the years 2001 through 2009, and the law that will go back into effect on January 1, 2011, unless Congress acts to change the law in effect at this time.

Section C explains the one year repeal of the estate tax that went into effect on January 1, 2010 and the current uncertainty of the federal estate tax law.

Section D summarizes the federal gift tax and Section E summarizes the federal generation skipping transfer tax.

Oregon and Washington also impose a tax on the transfer of assets by a decedent's estate. Section F summarizes the Washington estate tax, and Section G summarizes the Oregon inheritance tax. Neither state has a gift tax or a generation skipping transfer tax.

Section H sets forth two important steps that individuals should consider taking in connection with their estate plans, which may be especially important now due to the one year repeal of the federal estate tax.

Finally, there are numerous references throughout this article to the Transfer Tax Chart, which is set forth on page 8.

B. SUMMARY OF 2009 AND PRIOR FEDERAL ESTATE TAX

The federal estate tax exemption amounts and tax rates for the years 2001 through 2010 set forth on the Transfer Tax Chart at the end of this article became effective in 2001 when Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Under EGTRRA, the federal estate tax has been completely repealed for all of 2010.

Unless Congress acts to change the estate tax law between now and the end of 2010, the current estate tax law (EGTRRA) will “sunset” on December 31, 2010, and the law that was in effect prior to 2001 will go back into effect on January 1, 2011.

The remainder of this Section B describes the federal estate tax law that was in effect in 2009 and the law that will go back into effect on January 1, 2011, if Congress fails to act before the end of 2010.

The federal estate tax applies to transfers that occur, or are considered to occur, at death. It is an excise tax imposed on the transfer of the entire taxable estate of a decedent. A decedent’s gross estate includes all property in which the decedent had an interest at the time of his or her death. The gross estate includes the decedent’s interest in jointly held properties, the decedent’s retirement plans and IRA accounts, and assets held in the decedent’s revocable living trust. The gross estate also includes the proceeds of a life insurance policy payable to the decedent’s estate or over which the decedent retained any ownership interest.

Generally, all assets in the decedent’s gross estate are valued at their fair market value as of the decedent’s date of death. The term “fair market value” is defined in the federal tax regulations as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.” Although not required in all cases, professional appraisals are often used to establish the fair market value of business assets and real estate in a decedent’s estate.

As mentioned above, generally the assets of a decedent’s gross estate are valued as of the decedent’s date of death. However, the federal estate tax law allows an executor to make an election to value the decedent’s estate as of the date six months after the decedent’s date of death, or the date the asset is disposed of if earlier, if making the election decreases the decedent’s gross estate and the estate tax liability of the decedent’s estate. As a result of the decline in value of many types of investments in the last couple of years, this election was used by many estates to reduce the estate tax liability of the estate.

The **Estate Tax Exemption** (Column A on the Transfer Tax Chart) is the amount that can pass free of any federal estate tax. If the decedent's gross estate is less than the Estate Tax Exemption, the estate is not subject to estate taxes and is not required to file a federal estate tax return (Form 706). The Estate Tax Exemption was \$3,500,000 for deaths in 2009. Effective as of January 1, 2011, the Estate Tax Exemption will be reduced to \$1,000,000.

The taxable estate is the gross estate less all allowable deductions. Some of the more typical allowable deductions include the marital deduction for gifts to a surviving spouse, the charitable deduction for gifts to charity, the decedent's liabilities, funeral expenses, and the expenses of administering the decedent's estate. If the decedent's gross estate is equal to or exceeds the Estate Tax Exemption, the estate must file a Form 706. If the decedent's estate is required to file a Form 706, but the decedent's taxable estate (gross estate less allowable deductions) does not exceed the Estate Tax Exemption, no estate tax is owed.

The federal estate tax liability is determined by applying the estate tax rate to the decedent's taxable estate after adjustments for the decedent's lifetime taxable gifts. The estate tax rate applied to the excess of the taxable estate over the Estate Tax Exemption was 45% for deaths in 2009. Effective as of January 1, 2011, the estate tax rate will start at 41% and top out at 55% (with a 5% surcharge on estates between \$10,000,000 and \$17,184,000).

If the decedent's estate is required to file a Form 706, it must be filed, and any tax liability must be paid, within nine months after the decedent's date of death. The IRS will allow an automatic six month extension to file the Form 706; however, the extension to file does not extend the time to pay the tax.

The Typical 2009 Tax Plan For Married Couples

The typical 2009 and prior years tax plan for married couples uses wills or trusts that provide for a division of the estate of the first spouse to die into two shares. One share, usually referred to as the "Credit Shelter Amount", is an amount equal to the Estate Tax Exemption. The other share, usually referred to as the "Marital Share," is distributed outright to, or held in trust for, the surviving spouse. Since the decedent spouse's Estate Tax Exemption eliminates the estate tax on the Credit Shelter Amount, and the unlimited marital deduction eliminates the estate tax on the Marital Share, the result of the division is to eliminate the federal estate tax in the decedent spouse's estate. If properly designed and implemented, this plan allows a married couple to shelter from the federal estate tax at least two times the Estate Tax Exemption. Unless Congress enacts a permanent repeal of the federal estate tax and GSTT, which is very unlikely, this typical 2009 plan for married couples will likely continue to be the most commonly employed tax plan for married couples in 2011 and years thereafter.

C. THE 2010 REPEAL OF THE FEDERAL ESTATE TAX AND PRESENT UNCERTAINTY

As explained above, the federal estate tax exemption amounts and tax rates for the years 2001 through 2010 set forth on the Transfer Tax Chart at the end of this article became law when Congress enacted EGTRRA in 2001. Because Congress did not act before 2010 to stop the repeal

of EGTRRA in 2010, as of the writing of this article, there is no federal estate tax for estates of decedents who die in 2010. As mentioned above, unless Congress passes legislation to reinstate the federal estate tax before the end of 2010, in 2011 the federal estate tax will go back into effect with a reduced Estate Tax Exemption of \$1,000,000 and a tax rate that starts at 41% and tops out at 55% (with a 5% surcharge for very large estates) .

Stepped-up basis vs. carry over basis for 2010 estates

For deaths in 2010, the “stepped-up basis” rules have been replaced by “carry-over basis” rules. The “basis” of property is generally the purchase price of that property and is used to calculate taxable gain when the property is sold. A “step-up in basis” generally means that the basis of inherited property increases to the value of the property on the date of the decedent’s death. In 2009 and earlier years, inherited property generally received a step-up in basis, which meant that the recipient of the property could sell the property for a price equal to the stepped-up basis of the property and pay no capital gains tax.

“Carry-over basis” generally means the basis of inherited property remains the same as it was for the deceased owner; which potentially increases the amount of capital gains tax the recipient of the property must pay when the property is sold. Under the estate tax law in effect at this time, the recipient of inherited property can choose to take a “step-up” in basis for only \$1.3 million of the inherited property. For any amount inherited over \$1.3 million, the recipient’s basis will be the smaller of the deceased owner’s basis or the date-of-death market value of the property. The basis of property passing to a surviving spouse can be increased by an additional \$3.0 million.

Effective as of January 1, 2011, the “stepped-up basis” rules in effect in 2009 and earlier years will go back into effect.

What will Congress do?

Of course, it is impossible to predict what Congress is going to do. However, if Congress does pass legislation before the end of 2010 to reinstate the estate tax, it might make the tax effective retroactively as of January 1, 2010, or it might make the tax effective as of the date of the enactment. If Congress acts and the legislation is made retroactive, there will undoubtedly be a constitutional challenge to the retroactive application of the legislation. Congress might also remain deadlocked and allow 2010 to pass without any changes to the current estate tax law.

D. THE FEDERAL GIFT TAX.

The federal gift tax was not repealed in 2010 like the federal estate tax. However, effective as of January 1, 2010, the top federal gift tax rate was reduced from 45% to 35%. The lifetime gift tax exemption remains at \$1,000,000 for gifts in 2010.

The federal gift tax is a transfer tax on lifetime gifts. The federal gift tax applies to “taxable gifts.” Gifts that do not exceed the federal gift tax annual exclusion amount are not taxable gifts and are not subject to the federal gift tax. The gift tax annual exclusion amount is an annual per donee amount. For gifts made in 2010, the annual exclusion amount is \$13,000. The annual

exclusion amount is indexed for inflation and increases by increments of \$1,000 every few years. Generally, gifts are valued based on the fair market value of the transferred property at the time of the gift.

The **Gift Tax Exemption** (Column B on the Transfer Tax Chart) is the amount of taxable gifts an individual can make during his or her life without incurring any gift tax liability. Notice that although the Estate Tax Exemption was \$3,500,000 in 2009, the Gift Tax Exemption was only \$1,000,000.

Lifetime taxable gifts reduce the Estate Tax Exemption available to reduce the estate tax in the donor's estate upon the donor's death. For example, if the donor died in 2009 after using his or her entire Gift Tax Exemption of \$1,000,000, the Estate Tax Exemption available to the donor's estate would be \$2,500,000 (\$3,500,000 less \$1,000,000.)

With some limited exceptions for certain types of gifts (such as gifts that qualify for the marital or charitable deductions), a gift tax return must be filed if a donor makes any taxable gifts (gifts that exceed the gift tax annual exclusion amount). The due date for filing the gift tax return, and for paying any gift tax liability, is generally April 15th following the calendar year in which the taxable gift(s) is made. For gifts in 2009, the gift tax rate on gift amounts over the Gift Tax Exemption started at 41% and capped out at 45%. As mentioned above, the top gift tax rate for gifts in 2010 is 35%. Effective as of January 1, 2011, the Gift Tax Exemption will remain at \$1,000,000, but the gift tax rate will change from the 2010 top rate of 35% to a rate that starts at 41% and tops out at 55% (with a 5% surcharge for very large gifts).

E. THE FEDERAL GENERATION-SKIPPING TRANSFER TAX.

Like the federal estate tax, the federal generation skipping transfer tax (the GSTT) was repealed for one year effective as of January 1, 2010. Unless Congress acts, the federal GSTT that was in effect before EGTRRA will go back into effect on January 1, 2011.

The remainder of this Section E describes the GSTT law that was in effect in 2009 and the law that will go back into effect on January 1, 2011, if Congress fails to act by the end of 2010.

The GSTT is imposed on transfers of wealth that skip a generation. For example, grandparent A's gift to grandchild C is a generation-skipping transfer. Since A's child B will never own the gifted asset, the asset would not be taxable in B's estate when B dies. In the absence of the GSTT, affluent families could easily avoid multiple layers of transfer taxes by transferring their wealth to trusts designed to last for generations.

Each individual is entitled to a **GSTT Exemption** (Column E on the Transfer Tax Chart), which is the amount that can be transferred free of the GSTT. The GSTT Exemption Amount was \$3,500,000 for transfers made in 2009. The GSTT tax rate applicable to transfers that are subject to the GSTT is the highest estate tax rate (41% to 55%). Effective as of January 1, 2011, the GSTT will go back into effect with a GSTT Exemption amount of \$1,000,000 (indexed for inflation since 1999) and a tax rate equal to the highest estate tax rate.

F. THE STATE OF WASHINGTON ESTATE TAX.

Washington's estate tax applies to decedents dying on or after May 17, 2005. A Washington estate tax return must be filed if the decedent's gross estate exceeds \$2,000,000.

The Washington estate tax is calculated with reference to the decedent's "Washington taxable estate," which is defined as the decedent's taxable estate for federal estate tax purposes with three adjustments. First, the deduction for state death taxes is added back. Second, the amount of real or tangible personal property used primarily for farming purposes is subtracted. Third, the filing threshold amount (\$2,000,000) is subtracted.

After the Washington taxable estate is determined, the tax liability is determined by applying a tax table with incremental tax rates starting at 10% (for taxable estates up to \$1,000,000) and ending at 19% (for taxable estates that exceed \$9,000,000). The Washington estate tax return must be filed, and any tax liability paid, within nine months after the decedent's death, unless an extension is granted. Like the federal estate tax, Washington law also allows an executor to make an election to value the decedent's estate as of the date six months after the decedent's date of death, or as of the date the asset is disposed of, whichever date is earlier.

Prior to May 17, 2005, Washington imposed its own generation-skipping transfer tax; however, the Washington legislature repealed Washington's generation-skipping transfer tax effective for estates of decedent's dying after May 17, 2005.

Washington does not have a gift tax.

Recent Washington Legislation

As mentioned in the Introduction to this article, many existing wills and trusts with formula provisions based on the federal estate tax and GSTT law in effect before 2010, no longer make sense. In March of this year, the Washington legislature passed legislation to address this problem. In general, this legislation cures the problem with these wills and trusts by providing that unless the will or trust provides otherwise, any references to the federal estate tax or GSTT are deemed to refer to those laws as they applied with respect to estates of decedents dying on December 31, 2009. This legislation is retroactively effective as of December 31, 2009.

G. THE STATE OF OREGON INHERITANCE TAX.

In 2003, the Oregon Legislature passed HB 3072, which became effective on November 26, 2003. This law tied the Oregon inheritance tax to the Internal Revenue Code as it existed on December 31, 2000. HB 3072 applies to decedents dying on or after January 1, 1998. Like the federal estate tax, the Oregon inheritance tax is an excise tax on the transfer of a decedent's entire estate at death. The amount of the tax is equal to the maximum amount of the state death tax credit allowable against the federal estate tax under Section 2011 of the Internal Revenue Code (as it existed on December 31, 2000).

Prior to the passage of HB 3072, the Oregon inheritance tax was the type of state death tax commonly referred to as a "pick-up tax." Under the pick-up tax system, a decedent's estate was not subject to a state death tax if the decedent's estate did not owe a federal estate tax. If the decedent's estate owed a federal estate tax, the state death tax was an amount equal to the state death tax credit allowed under the federal law. As a result of the state's imposition of the pick-up tax, the state received an amount equal to the state death tax credit and the federal estate tax owing to the federal government was reduced by the same amount. Under the pick-up tax system, the total death tax liability of the decedent's estate was not increased by imposition of the state pick-up tax, and the state received a share of the tax that otherwise would have been paid to federal government.

By tying the Oregon inheritance tax to the federal estate tax as it existed on December 31, 2000, HB 3072 in effect "decoupled" the Oregon inheritance tax from the federal estate tax. Since this "decoupling," there has been a disparity between the federal Estate Tax Exemption (Column A on the Transfer Tax Chart), and the Oregon Exemption (Column G on the Transfer Tax Chart).

For deaths in 2010 (and until the Oregon Legislature changes it), the Oregon Exemption is \$1,000,000. A taxable estate of \$3,500,000 would incur an Oregon inheritance tax liability of \$229,200. (Column H on the Transfer Tax Chart).

The Oregon inheritance tax rate for taxable estates that exceed \$2,000,000 starts at 7.2% and caps out at 16% for taxable estates that equal or exceed \$10,100,000.

Column H on the Transfer Tax Chart shows the Oregon inheritance tax liability when the decedent's taxable estate equals the federal estate tax Estate Tax Exemption.

The Oregon inheritance tax return is due, and any tax liability must be paid, within nine months after the decedent's death, unless an extension is granted. Like the federal estate tax, Oregon law also allows an executor to make an election to value the decedent's estate as of the date six months after the decedent's date of death, or as of the date the asset is disposed of, whichever date is earlier.

Oregon does not have either a gift tax or a generation-skipping transfer tax.

Recent Oregon Legislation

Since the passage of HB 3072 in 2003, the Oregon Legislature has passed some additional important changes to the Oregon inheritance tax. Two of the most important changes are HB 2469 passed by the 2005 Legislature, which provides for the Oregon Special Marital Property Election (OSMP Election), and HB 3618 enacted during the 2008 Special Session, which provides for a credit against the Oregon inheritance tax for natural resource property and fishing business property.

The OSMP Election provides a solution to a potential tax problem for a commonly used version of the traditional tax plan for married couples (described above on pages 2 & 3). This commonly used plan establishes a Credit Shelter Trust that does not require all of the trust's income to be

distributed to the decedent's surviving spouse or that allows distributions to be made to the decedent's children as well as to his or her surviving spouse. If this type of credit shelter trust is funded with an amount that exceeds the Oregon Exemption, the decedent's estate will incur an Oregon inheritance tax liability. However, by making an OSMP Election and complying with the requirements of HB 2469, the executor of the decedent's estate can eliminate the Oregon inheritance tax in this situation.

HB 3618, which allows a credit against the Oregon inheritance tax for natural resource property and fishing business property, became effective on May 23, 2008, and applies retroactively to deaths occurring on or after January 1, 2007. "Natural resource property" is defined in HB 3618 to include farm use land and forestland. HB 3618 contains a chart that determines the amount of the credit by applying a specified percentage to the value of the natural resource property included in the decedent's estate. The percentage starts at 0.8% for credit eligible amounts that are between \$100,000 and \$150,000 and reaches a maximum rate of 13.6% for credit eligible amounts between \$7,100,000 and \$7,500,000. The maximum credit is \$705,200 for an estate that contains credit eligible property with a value of \$7,499,999.49. If the value of the credit eligible property is \$7.5 million or more, the credit quickly decreases, reaching zero when the value of the credit eligible property reaches \$15 million. If the decedent's adjusted gross estate exceeds \$15 million, no credit is allowed. No credit is allowed unless the value of credit eligible property is at least 50% of the decedent's total adjusted gross estate. In addition, the credit eligible property must be transferred to a member of the decedent's family. The natural resource property or the fishing business property must be used for five out of eight years following the decedent's death by a member of the family, or the registered domestic partner of the decedent.

Oregon has not passed any legislation to address the problem with formula clauses in wills and trusts that are based on the federal estate tax and GSTT that was in effect in 2009.

H. TWO IMPORTANT STEPS TO TAKE NOW.

Organize your records

Organize your records to show the cost basis of your properties, especially for your real property and securities (stocks and bonds). Consider asking your parents if they happen to have good records of the cost basis of their properties. If the carry over basis rules in effect in 2010 (see Section C) are not repealed by Congress, keeping good records of the cost basis of your properties can save a lot of work and a lot of headaches for your loved ones who inherit your properties.

See your attorney for an estate plan checkup

Many existing wills and trusts contain formula clauses, which express inheritance in terms of fractions or percentages. These fractions or percentages typically refer to the federal estate tax exemption amount or the tax marital deduction in the year of the decedent's death. These commonly used formulas in tax planning wills and trusts may not make sense if you die during 2010 when there is no federal estate tax. Married couples with formula clause wills and trusts should consult their estate plan attorney to see if their documents need to be amended.

TRANSFER TAX CHART

Year	Estate Tax Exemption (A)	Gift Tax Exemption (B)	Starting Tax Rate on Estate Above Exemption Amount (C)	Top Marginal Rate (D)	GSTT Exemption (E)	Washington Exemption (F)	Oregon Exemption (G)	Oregon Inheritance Tax * (H)
2001	675,000	675,000	37%	55%	1,060,000	No Tax	675,000	-0-
2002	1,000,000	1,000,000	41%	50%	1,100,000	No Tax	700,000	33,200
2003	1,000,000	1,000,000	41%	49%	1,120,000	No Tax	700,000	33,200
2004	1,500,000	1,000,000	45%	48%	1,500,000	No Tax	850,000	64,400
2005	1,500,000	1,000,000	45%	47%	1,500,000	2,000,000	950,000	64,400
2006	2,000,000	1,000,000	46%	46%	2,000,000	2,000,000	1,000,000	99,600
2007	2,000,000	1,000,000	45%	45%	2,000,000	2,000,000	1,000,000	99,600
2008	2,000,000	1,000,000	45%	45%	2,000,000	2,000,000	1,000,000	99,600
2009	3,500,000	1,000,000	45%	45%	3,500,000	2,000,000	1,000,000	229,200
2010	No Tax	1,000,000	No Tax	No Tax	No Tax	2,000,000	1,000,000	** 229,200
2011	1,000,000	1,000,000	41%	55%	1,300,000	2,000,000	1,000,000	-0-

* If taxable estate equals Estate Tax Exemption

** On a \$3,500,000 taxable estate

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