WASHINGTON ESTATE TAX:
TAX OVERVIEW AND PLANNING STRATEGIES

January 28, 2014

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I. INTRODUCTION.

The American Taxpayer Relief Act of 2012 (hereinafter 2012 Tax Act) brought about many changes, some of which will substantially change the frequency and types of tax planning that estate planners will recommend to clients. Two of the principal changes instituted by the 2012 Tax Act are the new indexed lifetime exemption amount ($5,340,000 for 2014) and the portability of any unused exemption amount from a deceased spouse to the survivor (technically referred to as the Deceased Spouse's Unused Exclusion or "DSUE"). The increased exemption and advent of portability will allow a married couple to transfer $10.68 million with little or no federal estate tax planning before the death of one spouse (although the use of the DSUE without additional planning has drawbacks). As a result, federal estate and gift tax will be a major issue for relatively few, and the tax planning focus for most Washington clients has now shifted from federal estate taxes to the federal income tax and state estate taxes. Due to these changes Washington estate taxes have become more important for many clients. This outline provides a brief overview of the structure of the Washington estate tax and describes several strategies frequently used to help clients reduce the impact of the tax.

II. WASHINGTON ESTATE TAX BASICS

A. **Highest Top Marginal State Estate Tax Rate in the United States**. The Washington estate tax was enacted in the wake of the repeal of the federal estate tax credit for state estate taxes in 2005. Washington's stand-alone estate tax does not specifically tie to the federal tax regime, although the Washington estate tax and related statutes and regulations rely heavily on federal tax law regarding definitions and concepts. Through the end of 2013Washington's top marginal estate tax rate was the highest out of all the states at 19%. However, the Washington legislature chose to increase the top marginal Washington estate tax rates to 20% for deaths occurring on or after January 1, 2014.

B. **Transfers Subject to Washington Estate Tax**. Generally, the Washington estate tax applies only to transfers of Washington property (see explanation below) taking effect at death. Washington does not currently impose a gift tax, and as such, lifetime gifts of Washington property escape Washington estate tax. Lifetime gifts do not reduce the amount of assets that can be transferred at death without being subject to the Washington estate tax (i.e. lifetime gifts do not consume part of the Washington exemption amount).

C. **Defining Washington Property**. "Washington property" for purposes of the Washington estate tax includes the following:

1. Interests in Real Property located in Washington. Washington property includes any interest in real property that is physically situated in Washington. In addition to directly owned fee simple real property ownership, taxed interests include leasehold interests, mineral interests, beneficial interests in trusts that own interests in Washington real estate, and joint or concurrent ownership interests. See WAC 458-57-125(4)(a). However, real property interests do not include interests in federal land trusts or interests

in corporations, partnerships, LLCs or other entities which own interests in Washington real property.

2. Tangible Personal Property located in Washington at death. Washington property includes tangible personal property physically located in the state at the time of death; provided, however, it does not include tangible personal property owned by a nonresident if the property is merely transiting/passing through the state at the time of the owner's death. WAC 458-57-125(4)(b).

3. Intangible Personal Property of Washington Residents. Intangible personal property is only considered Washington property if it is owned by a Washington resident. For purposes of the Washington estate tax, Washington residents are individuals who have a Washington domicile at their date of death. Intangible personal property includes cash, investment vehicles, securities, interests in business entities such as corporations and LLCs, and any other assets that are not tangible and do not have an intrinsic value to itself. For example, gold certificates do not have value in and of themselves; however, gold bars are both tangible and have intrinsic value. Accordingly, gold bars are considered tangible personal property whereas a certificate evidencing ownership of the same gold is intangible.

a. A key issue in determining whether intangible personal property is Washington property or otherwise, is whether the decedent was domiciled in Washington at the time of death. Under Washington law, the elements of domicile are: (1) residence in fact (i.e. physical presence); and (2) intent to make that residence one's home. See *In re Marriage of Strohmaier*, 34 Wn. App. 14 (1983).

b. Once a domicile is established it is presumed to continue until another domicile is established. Accordingly, a person domiciled in Washington, will continue to be a Washington resident for purposes of the Washington estate tax until that person has a physical residence outside of the state and intends to make that out-of-state residence his/her primary home (See paragraph III.C below).

D. **Washington Exemption - $2,012,000 in 2014)**. To the extent a decedent's gross estate does not exceed the exemption amount (now referred to as the "applicable exclusion amount" in RCW 83.100.020), the decedent's estate will not owe Washington estate tax. When the current form of the Washington estate tax was enacted in 2005, the Washington estate tax exemption was $1.5 million. The following year (2006) the exemption was increased to $2 million, and it remained at that level through the end of 2013. However, starting in 2014, the $2 million exemption is adjusted for inflation and will be $2,012,000 for deaths occurring in 2014. The inflation adjustments are tied to the consumer price index published by the United States bureau of labor statistics for the Seattle-Tacoma-Bremerton metro area. It is worth mentioning, that the $2 million exemption will only be adjusted upward, and if there is "deflation" the exemption will remain the same amount as the previous year.

E. **Filing Requirements.** An estate is required to file a Washington estate tax return if the gross estate (as contemplated in IRC §2001) contains Washington property and:

1. the estate is required to file a federal estate tax return (Form 706); <u>or</u>
2. the gross estate has a value in excess of $2,000,000 (for decedents dying after January 1, 2006), regardless of whether tax is due. For deaths occurring after 2013 the $2,000,000 threshold is increased by consumer price index adjustments.

Estates of decedents who die after January 1, 2006 that are required to file a federal Form 706 must file a Washington Form 850049e. Estates of decedents who die after January 1, 2006 that are not required to file a Form 706 will file Washington Form 850046e.

F. **<u>Basic Tax Calculation Concepts</u>**. A thorough understanding of how the Washington estate tax is calculated requires a comprehensive understanding of federal estate tax law as well as a thorough review of applicable RCWs, WACs, and the Washington estate tax form and instructions. The purpose of this section is to briefly illustrate the main components of the Washington estate tax calculation; this is not a comprehensive review of the many issues and nuances that may come up when preparing a Washington estate tax return or calculating the tax. The basic Washington estate tax calculation is illustrated as follows:

$$\boxed{\text{Washington Taxable Estate}} \times \boxed{\text{Tax Rate (see tax table*)}} = \boxed{\text{Gross Washington Tax}}$$

$$\boxed{\text{Gross Washington Tax}} \times \boxed{\frac{\text{Washington Property}}{\text{Gross Estate (All Property)}}} = \boxed{\text{Washington Estate Tax}}$$

* the Washington estate tax rate table that was in effect **<u>through 12-31-13</u>** is as follows:

If Washington Taxable Estate (amount exceeding $2 M exemption)		The Amount of Tax Equals		Of Washington Taxable Estate Value Greater Than
Is at Least	But Less Than	Initial Tax Amount	Plus Tax Rate %	
$0	$1,000,000	$0	10.00%	$0
$1,000,000	$2,000,000	$100,000	14.00%	$1,000,000
$2,000,000	$3,000,000	$240,000	15.00%	$2,000,000
$3,000,000	$4,000,000	$390,000	16.00%	$3,000,000
$4,000,000	$6,000,000	$550,000	17.00%	$4,000,000
$6,000,000	$7,000,000	$890,000	18.00%	$6,000,000
$7,000,000	$9,000,000	$1,070,000	18.50%	$7,000,000
Above $9,000,000		$1,440,000	19.00%	Above $9,000,000

* the Washington estate tax rate table in effect **as of January 1, 2014** is as follows:

If Washington Taxable Estate (amount exceeding $2 M exemption)		The Amount of Tax Equals		Of Washington Taxable Estate Value Greater Than
Is at Least	But Less Than	Initial Tax Amount	Plus Tax Rate %	
$0	$1,000,000	$0	10.00%	$0
$1,000,000	$2,000,000	$100,000	14.00%	$1,000,000
$2,000,000	$3,000,000	$240,000	15.00%	$2,000,000
$3,000,000	$4,000,000	$390,000	16.00%	$3,000,000
$4,000,000	$6,000,000	$550,000	18.00%	$4,000,000
$6,000,000	$7,000,000	$910,000	19.00%	$6,000,000
$7,000,000	$9,000,000	$1,100,000	19.50%	$7,000,000
Above $9,000,000		$1,490,000	20.00%	Above $9,000,000

The Washington estate tax calculation is illustrated by the following basic **example**:

Maude, a single Washington resident, died in 2012 and at the time of her death she owned the following property (all of which passed to her children):

Description	Value	Washington Property
Savings/Checking	$ 25,000	Yes
Investment Account	$1,000,000	Yes
Washington Home	$ 500,000	Yes
ND Mineral Interests	$1,500,000	No
Total Gross Estate	**$3,025,000**	

Assume that deductible administrative expenses were $25,000 so that Maude's federal taxable estate was $3,000,000, which, after the $2,000,000 Washington exemption, leaves Maude with a Washington taxable estate of $1,000,000. Maude's Washington estate tax is $50,413; calculated as follows:

$$\boxed{\$1{,}000{,}000} \times \boxed{\text{Tax Rate from tax table (10\%)}} = \boxed{\$100{,}000}$$

$$\boxed{\$100{,}000} \times \boxed{\frac{\$1{,}525{,}000}{\$3{,}025{,}000}} = \boxed{\$50{,}413}$$

G. **Definition of Washington Taxable Estate**. Washington taxable estate is defined in RCW 83.100.020(14), and the definition begins with a reference to the federal taxable estate and lists certain modifications. The definition of federal taxable estate for purposes of the Washington estate tax is as defined in the IRC as it existed on January 1, 2005, without any reduction attributable to any death taxes imposed by a state. The RCW provision goes on to list certain modifications to federal taxable estate that result in the Washington taxable estate. The primary modifications to federal taxable estate to arrive at the Washington taxable estate are as follows.

Federal Taxable Estate

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Add:

State Estate Tax Deduction (IRC §2058)

Amount of Federal QTIP and QDOT Elections

Property transferred by predeceased spouse for which a Washington QTIP Election was made ("RCW 83.100.047 Property")

(-)

Subtract:

$2 Million Washington Exemption (subject to index adjustments)

Amount of Washington Farm Deduction

Amount of Washington Family Owned Business Deduction

Amount of Washington QTIP and QDOT Election

Property transferred by a predeceased spouse for which a federal QTIP election was made if the predeceased spouse also made a Washington QTIP election.

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Washington Taxable Estate

1. Anti-*Bracken* Legislation. Pursuant to recently enacted legislation (Engrossed House Bill 2075, 2013-2014), which applies to all estates retroactively, the Washington Taxable Estate includes the value of any property included in the decedent's taxable estate pursuant to IRC §2044 (property subject to a federal QTIP election by a predeceased spouse – "§2044 property"), irrespective of when the federal QTIP election was made. As such, a decedent's Washington Taxable Estate will include the value of any §2044 property even if the QTIP election was made before the current Washington estate tax was enacted and even if the predeceased spouse was not a Washington resident and owned no Washington property at the time such predeceased spouse died. The only time §2044 property will not be included in the Washington Taxable Estate is when the predeceased spouse also made a separate Washington QTIP election, then to the extent there is property for which a federal QTIP election, but no Washington QTIP election, the value of that property will not be included in the surviving spouse's Washington Taxable Estate upon his or her death.

2. Washington Marital Deduction- Outright Transfers. Outright transfers that qualify for the federal marital deduction also qualify for a marital deduction for Washington estate tax purposes. In contrast to the federal rules we are accustomed to, Washington also allows the marital deduction for transfers to a same-sex surviving spouse. However, pursuant to *Windsor* (*Windsor v. US*, 133 S. Ct. 2884, 2013 U.S. LEXIS 4935) the estates of same-sex spouses who are married in, and die while domiciled in, states that recognize same-sex marriages are entitled to claim the federal marital deduction. Beginning in 2014, a state registered domestic partner will be deemed to be a surviving spouse with respect to deductions for marital transfers under the Washington estate tax. This will include outright transfers, transfers of qualified terminable interest property, and transfers of property to a qualified domestic trust for the benefit of a noncitizen registered domestic partner. See RCW 83.100.047.

3. Washington QTIP Election. Washington law provides for a state only Qualified Terminable Interest Property election. A Washington QTIP election may be a larger or smaller than the portion for which a federal QTIP election was made. To calculate the Washington taxable estate the value of assets subject to the federal QTIP election is added back to in the Washington tax calculation and the Washington QTIP election amount is deducted. Therefore it is necessary to make a specific Washington QTIP election to defer the Washington estate tax on any transfers of terminable interest property to a surviving spouse or registered domestic partner. While not specifically stated in the Revised Code or Administrative Codes, it is implied that the terminable interest property must be qualified as described in IRC § 2056(b)(7) in order for the transfer to qualify for the QTIP election. See WAC 458-57-115(2)(c)(iii).

4. Washington QDOT Election. Washington law also provides a state only Qualified Domestic Trust election for situations where property passes to a noncitizen surviving spouse and where a substantial marital deduction is desired. For more information, see WAC 458-57-115(2)(c)(iv).

5. Washington Farm Property Deduction. A special farm property deduction from the Washington taxable estate is available for the value of "qualified real property" and any tangible personal property included in a decedent's estate if such property was used for qualified farming purposes. This special deduction has been available since the current form of the Washington estate tax was enacted in 2005. A summary of basic details about the deduction and requirements to qualify for the deduction follows.

   a. Definitions.

      i. Qualified Real Property. Qualified real property is real property that was used for a "qualified use" at the date of the decedent's death, and passes from the decedent to a qualified heir.

      ii. Qualified Heir. A qualified heir is a member of the decedent's family, who acquired property from the decedent.

      iii. Member of the decedent's family. A member of the decedent's family includes: the descendant's ancestors; the decedent's spouse; lineal descendants of the decedent, the decedent's spouse, and/or the decedent's parents; and the spouse of any lineal descendant. Beginning in January, 2014, state registered domestic partners will be treated as spouses for purposes of determining the decedent's family members for the farm deduction.

      iv. Qualified Use. Qualified use means property used as a farm or for farming purposes

      v. Farm. Farm includes stock, dairy, poultry, fruit, fur bearing animals, and truck farms; plantations; ranches; nurseries; ranges; greenhouses or other similar structures used for raising agricultural products; and orchards and woodlands.

      vi. Farming Purposes. Farming purposes means: (1) cultivating soil, raising or harvesting agricultural/horticultural products, including animals; (2) handling, drying, packing, grading, or storing agricultural commodities in its unmanufactured state but only if the owner/tenant/operator regularly produces more than ½ of the commodity treated; (3) planting, cultivating, and cutting trees; or (4) preparing trees (other than milling) for market.

   b. Eligibility to Claim the Deduction. The deduction may only be claimed if:

      i. 50% or more of the adjusted value of the gross estate (gross estate without regard to any special valuation under IRC §2032A and reduced by mortgages and indebtedness under IRC §2053(a)(4)) consists of real or personal property used for a qualified use by the decedent or decedent's family at the time of death.

ii. 25% or more of the value of the adjusted gross estate consists of qualified real property used for qualified farming purposes. (*Note:* the deduction may be available for tenant farmers if more than 50% of the estate consists of personal property used for qualified farming purposes).

iii. For five of the eight years preceding the decedent's death the real property was owned by the decedent or the decedent's family and the decedent or the decedent's family materially participated in the operation of the farm. Material participation is determined in accordance with the rules applicable to IRC §1402(a)(1) (i.e., self-employment tax rules).

iv. The decedent must be a US citizen at the time of death.

v. The property must pass to one or more qualified heirs.

c. No limits on amount of deduction or use following transfer. There is no limit on the amount of the farm property deduction available to an estate. Furthermore, there is no requirement that the recipient qualified heir(s) use the property for qualified farming purposes following the decedent's death. Accordingly, the qualified heirs may sell farm property received to a residential or commercial developer without impacting the eligibility for the deduction or altering the farm property deduction tax benefits. For more information on the farm deduction see WAC 458-57-155.

6. Washington Family-Owned Business Deduction. Beginning in 2014, a special Washington estate tax deduction will be allowed for the value of "qualified family-owned business interests" included in a decedent's estate. A summary of basic details about the deduction and requirements to qualify for the deduction follows.

a. Definition of Qualified Family-Owned Business Interest. A "qualified family-owned business" has the same meaning as provided in IRC §2057(e), which includes:

i. An interest in a sole-proprietorship that carries on a trade or business.

ii. An interest in an entity that carries on a trade or business, if:

1. 50% of such entity is owned (directly or indirectly) by the decedent and members of the decedent's family;

2. 70% of such entity is owned by members of 2 families; or

3. 90% of such entity is owned by members of 3 families.

However, if the entity qualifies under 2 or 3 immediately above, the decedent's family must own at least 30% of such entity.

There are various exceptions to the definition of "qualified family-owned business," which are specified in IRC §2057(e)(2), including that the principal place of the trade or business must be located within the United States. See IRC §2057(e)(2) for more exceptions to the definition.

b. Eligibility to Claim the Deduction. The deduction is limited to $2.5 million and may only be claimed if at least 50% of the decedent's Washington taxable estate (determined without regard to the $2.0 M estate tax exemption) is comprised of interests in a family-owned business; and:

   i. The decedent or the decedent's family owned the interests and materially participated (within the meaning of IRC §2032A(e)(6), which ties to the employment tax rules) in the applicable family-owned business for five of the eight years preceding the decedent's death;

   ii. The family-owned business interests pass to a "qualified heir" (same as described in the farming property deduction above) from the decedent;

   iii. The qualified heir must continue to own the family-owned business interests and the decedent's family must materially participate in the business for three years following the decedent's death (*see* II.G.6.c below).

   iv. The decedent is a United States citizen or resident at the time of death;

   v. The value of the decedent's family-owned business interests is not more than $6 million; and

   vi. Only amounts included in the decedent's federal taxable estate may be deducted for purposes of the Washington estate tax (*Note*: will not apply to business interests included in decedent's Washington estate due solely to a Washington-only QTIP election by a predeceased spouse).

c. Business Interests subject to tax if disposed or family does not materially participate. The family-owned business deduction will be retroactively disallowed and tax (plus interest from the date that is nine months following the decedent's date of death) will be imposed upon the recipient heir if, within three years following the decedent's death, the qualified heir disposes of the interest, other than to a family member or for a qualified conservation contribution; the qualified heir loses his or her United States citizenship; the principal place of the trade or business of the applicable business ceases to be located in the United States: or a member of the decedent's family ceases to materially participate in the business.

H. **Important Concepts Commonly Involved in Tax Reduction Techniques**. The Washington estate tax mitigation techniques addressed in this outline are based on three concepts inherent in the Washington estate tax law, which are:

1. Washington Estate Tax Exemption. Each estate subject to the Washington estate tax is entitled to a $2,000,000 exemption, which, beginning in 2014, will be subject to index adjustments (*see* II.D above). This deduction is frequently referred to as the Washington exemption due to the fact it operates much like the federal lifetime estate tax exemption except for the fact that the full $2,000,000 (as adjusted for inflation) is available upon the death of a decedent irrespective of the extent of the decedent's lifetime gifting activities. It is important to note that there is no portability of the Washington exemption. Therefore, spouses typically need to implement some level of planning (e.g. credit shelter trust for benefit of surviving spouse) while they are both living if they intend to utilize the Washington exemptions of both spouses.

2. Apportionment of Tax Based on Asset Situs. Since the Washington estate tax only applies to the transfer of Washington property, the tax is apportioned among the gross estate assets based on the situs of each asset pursuant to a state apportionment fraction (*see* II.B and C, above). Accordingly, the lower the relative value of assets included in an estate that are considered Washington property, the lower the Washington estate tax.

3. §2044 Property is Excluded from Washington Taxable Estate. Property that was transferred from a predeceased spouse for which a federal qualified terminable interest property (QTIP) election was made (§2044 Property) is not includable in the Washington taxable estate of the surviving spouse only if the predeceased spouse also made a Washington QTIP election. Accordingly, if the predeceased spouse's estate did not make a Washington QTIP election, the amount of any §2044 property attributable to a federal QTIP election is included in the Washington taxable estate of the surviving spouse.

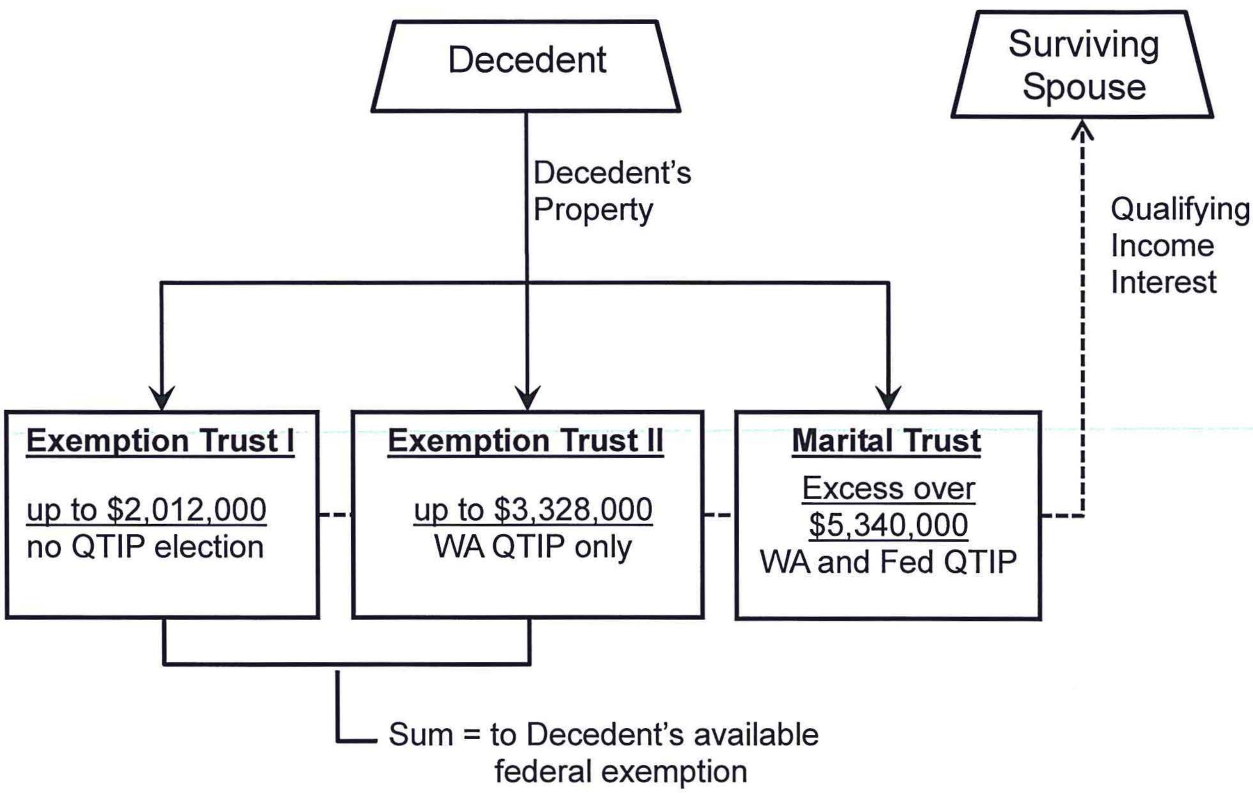
III. TAX REDUCTION TECHNIQUES

As discussed earlier, the new focus of tax planning for many clients is to reduce the potential for both the Washington estate tax and the federal income tax. The primary federal income tax mitigation technique we consider in this outline is achieving the step-up in income tax basis upon the death of a person or, where applicable, a basis step-up upon the death of both spouses when dealing with a married couple. While the strategies used to reduce Washington estate tax may preclude a step-up in basis upon death, potential strategies exist that enable a taxpayer to achieve the best of both worlds (reduce Washington estate taxes and federal income taxes). The following tax mitigation strategies are primarily aimed at addressing the Washington estate tax; however, this outline will identify strategies that can be employed to mitigate federal income tax as well. There are also strategies (not discussed in this outline) that address only the federal income tax component to our considerations.

A. Washington Exemption Planning.

1. Exemption Maximization for Married Taxpayers. Although federal credit shelter planning may be less utilized following the introduction of portability, Washington exemption preservation planning is still one of the best strategies to mitigate the Washington estate tax for married couples. As there is no Washington corollary to the portability of the federal exemption, the traditional "credit shelter" or "spousal by-pass" trust planning is still frequently utilized to ensure that a married couple is able to transfer $4 million (to be adjusted for inflation) of assets to heirs in a Washington estate tax free manner.

   Following is a diagram which illustrates an estate plan structure (using 2014 exemption amounts) that was and is commonly used by married couples to maximize use of federal and Washington exemptions and defer any estate tax until the death of the surviving spouse:



   Following the death of the first-to-die spouse, his or her assets or share of the community property is allocated into various trusts. Each trust serves a specific purpose, which is generally described as follows:

   a. Exemption Trust I. Exemption Trust I is typically funded with assets up to the value of the Washington estate tax exemption or $2,012,000 in 2014. (However for the sake of simplicity, the Washington exemption amount, as adjusted for inflation, will be hereinafter referred to in this outline as $2 million*.)

The purpose of Exemption Trust I is to maximize the use of the decedent's Washington exemption and up to $2 million* of his/her federal exemption. The assets of this trust will continue to be available (all income and principal subject to ascertainable standards) to the surviving spouse for his/her lifetime; however, such assets will be excluded from the surviving spouse's taxable estate for both federal and Washington purposes.

b. Exemption Trust II. Exemption Trust II is designed to maximize use of the decedent's federal exemption amount above the $2 million* used by the transfer to Exemption Trust I, and defer any Washington estate tax until the death of the survivor by making a Washington QTIP election with respect to the trust's assets. No federal QTIP election is made with respect to the assets so that the decedent's federal estate tax exemption is utilized to the extent possible. Upon the death of the survivor, the assets in Exemption Trust II will be excluded from the survivor's federal taxable estate but included in his/her Washington taxable estate.

c. Marital Trust. The Marital Trust is designed to defer any federal and state estate taxes until the death of the survivor. It is funded with assets exceeding the value of the decedent's available federal exemption amount. The estate tax objective for this type of trust is to defer any federal and state estate tax until the death of the surviving spouse without making an outright transfer to the spouse; however, nontax objectives can also be achieved by using this type of trust. If the only reason the decedent left assets in trust for his or her surviving spouse was to defer estate taxes, the same objective could be accomplished through an outright distribution to the surviving spouse.

d. Income Tax Saving Approaches.

i. Federal QTIP Election over Trust Assets Excluded from Washington Estate. If the survivor wants the assets of Exemption Trust I and/or Exemption Trust II to receive an income tax basis step-up upon the survivor's death, and simply wants to preserve the Washington exemption of the decedent, a federal QTIP election can be made with respect to the assets in both trusts (all or part). The federal QTIP election will not affect the use or benefit of the decedent's Washington estate tax exemption, because the assets of Exemption Trust I will be excluded from the survivor's Washington taxable estate. However, such assets will also receive a basis step-up pursuant to IRC §1014 when the survivor dies because the assets will be §2044 property and be deemed to be received from the survivor following his/her death. The federal QTIP election for both trusts will preserve the decedent's unused exemption through portability (assuming there is no election out of portability on the federal estate tax return) and the decedent's unused exemption (DSUE) will be added to the survivor's available federal lifetime exemption.

ii. Confer to Independent Trustee the Power to Distribute Assets Outright to Surviving Spouse or Grant a Testamentary General Power of Appointment (TGPOA) to the Surviving Spouse. Options to achieve a step-up in the income tax basis of all or any of the assets in Exemption Trust I or Exemption Trust II are to confer a power to an independent trustee to distribute all or any of the trust assets outright to the surviving spouse or to grant a TGPOA over all or any of such assets to the surviving spouse. If such power is exercised by the independent trustee, the corresponding assets in the subject trust will be included in the surviving spouse's federal taxable estate pursuant to IRC §2033 or IRC §2041, whichever may apply, and therefore receive a basis adjustment pursuant to IRC §1014 upon the surviving spouse's death. A benefit to these approaches is that each allows the trustee to use a "wait and see" approach and possibly estimate with relative precision the intended income tax by exercising either power. However, a potential drawback to this approach is that all of the trust assets that are distributed or are subject to the TGPOA will be included in the surviving spouse's Washington taxable estate.

2. Asset Selection for Exemption Trust Funding. The strategic selection of assets for funding a trust that will be exempt from Washington estate tax upon the death of a surviving spouse can produce significant tax savings. Consider the following example:

Annie and Sam were married Washington residents when Sam died in 2013. At the time of Sam's death, Annie's and Sam's sole assets were community property and they included the following:

Description	**Value**	**Situs**
Washington Real Property	$2,000,000	Washington
Texas Mineral Interests	$2,000,000	Texas
Intangible Personal Property	$2,000,000	Washington
Total	$6,000,000	

Following Sam's death, Annie funds two trusts established under Sam's Will as follows:

Exemption Trust I	**Exemption Trust II**
Washington Real Property $2,000,000 No WA QTIP Election	Intangible Personal Property $1,000,000 WA QTIP Election

Assuming that Annie dies while all the assets have the same value as of Sam's death, Annie's Washington taxable estate will consist of the following assets:

Description	**Value**	**Situs**
Texas Mineral Interests	$2,000,000	Texas
WA QTIP Property from Sam	$1,000,000	Washington
Intangible Personal Property	$1,000,000	Washington
Total	$4,000,000	

Annie's gross Washington estate tax will be $240,000; however, because her estate includes non-Washington property ($2,000,000), the tax is apportioned $2,000,000/$4,000,000 to Washington and as such the actual estate tax is only $120,000.

However, if the Texas real property had been funded to Exemption Trust I, all assets included in Annie's estate would have been Washington property, the tax would not have been apportioned to out-of-state property, and as a result the tax would have been $240,000. As such, strategic trust funding would save the heirs $120,000 in this scenario.

As illustrated by this example, practitioners should consider the potential state estate taxes upon the death of the surviving spouse, when selecting assets to fund trusts that will be exempt from, or subject to, tax upon the death of a surviving spouse.

B. **Lifetime Gifting**.

1. Outright Gifting. Since Washington does not impose any tax on lifetime transfers and gifts in the form of either a direct gift tax or reduction to the $2 million* Washington exemption available at death, Washington estate tax can be substantially reduced by simply transferring assets to heirs (or other intended beneficiaries) before death. The obvious costs of gifting are the loss of control and benefit from the asset after the gift and the loss of step-up in income tax basis that will occur upon death. When considering making substantial gifts to mitigate Washington estate tax various factors should be analyzed, such as:

a. Gifting to Reduce Size of Estate. If gifts can be made to reduce the donor's Washington taxable estate below $2 million* at the date of death, the gifting will completely eliminate the Washington estate tax. Furthermore, if the decedent's gross estate is below $2 million*, there will be no requirement to file a Washington estate tax return, which will result in an added financial benefit of the gift.

b. Gift Washington Property if Possible. Strategically selecting assets for gifting that will reduce the Washington property numerator in the estate tax apportionment fraction will typically reduce the Washington estate tax more than gifting out-of-state property.

c. Analyze Income Tax Impact of Gifting. Assets gifted during life will not receive a step-up in income tax basis; therefore, it is necessary to compare the potential income tax liabilities that may be incurred with a carryover basis (gift) as compared to the liabilities that may be incurred with a stepped-up basis (transfer after death). The Washington estate tax is imposed at rates ranging from 10% to 20% and the tax will apply to the total value of the asset transferred at death. The maximum federal income tax rate on capital gains is 23.8% and the maximum ordinary income tax rate is 43.4% (when considering the 3.8% Medicare surtax imposed by the Affordable Care Act); however, the income tax does not apply to the entire amount received on the disposition of the assets (it only applies to the amount received less tax basis). One strategy to mitigate the negative tax consequences is to gift assets with a high basis, while retaining the low basis assets in the estate to receive a basis step-up upon death.

d. Avoid Gifting Assets that will Qualify for a Deduction. Certain assets, such as farm property and family owned business interests, may be eligible for a Washington estate tax deduction, which will allow those types of assets to pass tax free to heirs even if they are included in the decedent's gross estate. Because no Washington tax will be imposed on such assets, there is generally little benefit to gifting such assets pre-death from an estate and/or income tax perspective.

2. Gift to Irrevocable Trust. Individuals are often reluctant to gift due to the fact that they lose complete control of the gifted assets or that the donee (who may be a minor or irresponsible) will have complete control over the gifted assets. One strategy to address those concerns is to gift assets to an irrevocable trust established for the heirs. If the assets in the trust will be excluded from the Washington taxable estate, the assets must be excluded from the federal estate as well. Accordingly, a gift to an irrevocable trust that is effective in avoiding Washington estate tax will preclude the basis step-up that would potentially occur on death. Therefore, care should be taken in selecting the assets to be gifted to irrevocable trusts for heirs.

3. Transfer of Beneficial Interests in QTIP Trust. To qualify for the federal QTIP election, a surviving spouse must have a "qualifying income interest" in the subject property for life. The effect of a QTIP election is to allow a terminable spousal interest in the property to qualify for the marital deduction upon the transfer from the predeceased spouse and defer any transfer taxes on the subject property until the death of the survivor. The assets subject to the QTIP election are included in the surviving spouse's estate pursuant to IRC §2044, and those assets are sometimes referred to as "§2044 property." IRC §2519 provides that any transfer or disposition of the surviving spouse's qualifying income interest during his or her lifetime is treated as a gift of all the underlying property to which the QTIP election applies.

a. Transfer of Interest in Property for which a federal QTIP election was made. If a surviving spouse transfers her qualifying income interest in a trust (or property) for which a federal QTIP election was made, the trust's assets would be treated as if they were transferred by gift during the survivor's lifetime and would therefore be excluded from the survivor's federal taxable estate (and Washington taxable estate) upon the death. If significant Washington estate tax will be paid on assets that are subject to a predeceased spouse's estate's QTIP election, making the gift and losing the basis step-up may be well worth the savings.

b. Transfer of an Interest in property for which only a Washington QTIP election was made.

i. An issue that is less clear, but worth considering, is whether a surviving spouse may transfer his or her lifetime interests in property for which a Washington QTIP election was made (but for which no federal QTIP election was made), in an attempt to exclude the underlying assets from the Washington taxable estate upon his or her death. If the surviving spouse transfers any interest he or she has in the subject assets to the remainder beneficiaries of the property, and the remainder beneficiaries receive the property outright following such transfer, it would seem that any transfer is completed during the survivor's lifetime and no transfer will occur on his or her death.

ii. Since 2005 trusts have been established to preserve a deceased spouse's substantial federal estate tax exemption, but due to the lower Washington exemption amount, such trusts were the subject of a QTIP election made only for Washington tax purposes. As such, a transfer of the surviving spouse's interests in a trust for which no federal QTIP election was made may remove such trust's assets from the surviving spouse's Washington taxable estate without triggering any taxable transfer for federal tax purposes. Because no federal QTIP was made with respect to such trust, the transfer will not be treated as a gift under IRC §2519 for federal gift tax purposes. Additionally, since the property in such trust will not receive a step-up in income tax basis upon the death of the survivor under §1014, there is no income tax cost in making the transfer (because the adjustment will not occur even if the property is included in the survivor's Washington taxable estate). Although there is some uncertainty in the ultimate Washington estate tax consequences to a surviving spouse when he or she makes a lifetime transfer of his or her interests in property for which a Washington QTIP election was previously made, it should be considered when reviewing strategies to reduce a client's potential Washington estate tax obligation.

C. **Change Domicile**. The Washington estate tax is imposed at rates ranging from 10% to 20%. Washington's 20% estate tax rate is the highest state estate tax rate imposed in the United States. Due to the fact that there are a number of states which do not impose any form of death tax, an easy solution to reduce or eliminate the Washington estate tax altogether is to move to a state which imposes no, or lower, estate taxes. As indicated above, the Washington estate tax only applies to Washington property and Washington property does not include intangible personal property owned by nonresidents. The tax savings that may result from the change of the situs of intangible property that occurs upon relocating one's domicile may be well worth cost/burden of the move.

The impact of changing one's domicile to save Washington estate tax is illustrated in the following example:

Maj, a single person, owned the following assets at her death:

Description	Value
Washington Residence	$1,000,000
California Residence	$1,000,000
Intangible Personal Property	$3,000,000
Total	$5,000,000

If Maj dies as a resident of Washington or as a resident of California, her respective state estate tax obligations will be as follows:

State of Residence	Washington	California
Washington Estate Tax	$312,000	$ 78,000
California Estate Tax	$ 0	$ 0
Total State Estate Tax	$312,000	$ 78,000

1. States with No Death Taxes. The following states do not currently (as of June 2013) impose any form of death tax:

   Alaska, California, Nevada, Idaho, Montana, Wyoming, Utah, Arizona, New Mexico, Colorado, North Dakota, South Dakota, Kansas, Oklahoma, Texas, Louisiana, Arkansas, Missouri, Wisconsin, Michigan, Alabama, Mississippi, Ohio, West Virginia, Virginia, South Carolina, Georgia, Florida, and New Hampshire.

2. Elements of Domicile. Under Washington law, domicile is determined where the person physically resides and intends to make that residence his/her primary home. Once domicile is established it does not change until that person establishes a different domicile. See *In re Estate of Lassin*, 33 Wn.2d 163 (1949). Accordingly, to move from a Washington domicile the individual must: (1) move to a residence located out-of-state; and (2) intend to make that residence his/her primary home. If an individual only has one residence or has clearly made her

primary home at a specific residence, determining that individual's domicile is not complicated. However, if an individual has multiple residences, or has not clearly chosen her "main home," ascertaining her domicile can be more complicated and lead to disputes with the Washington Department of Revenue if additional tax is at stake. When planning to move domicile for tax savings purposes it is important to remember that self-serving statements regarding an individual's intent regarding domicile receive less evidential weight than do the surrounding facts and circumstances and the individual must act in a manner that is consistent with a true change of domicile.

For a good example of the facts and circumstances the Department will consider in making its determination with regard to domicile see the Department's "Affidavit Substantiating Decedent's State of Domicile at Death" (Form REV 85 0045 (11/18/09)).

3. <u>Intent to Establish Domicile and Incapacity</u>. An issue that is sometimes encountered is whether the domicile of an individual can be changed after that individual loses testamentary capacity. As intent to make a residence one's home is an indispensable element to establish domicile, it is questionable whether an individual with diminished capacity can intend to make any place their primary home.

   While the effectiveness is disputable, it may be worthwhile for an individual to include a statement in his/her healthcare power of attorney or similar documents to the effect that the principal intends to reside and make his/her home at the location determined by his/her attorney-in-fact. As a note of caution, providing this type of authority to an attorney-in-fact could potentially help an incapacitated person change their domicile after suffering incapacity, but the ultimate effectiveness in actually changing the individual's domicile for tax purposes is questionable.

   Granting an attorney-in-fact the authority to change an incapacitated individual's domicile would likely produce advantages as well as drawbacks. The potential heirs of an incapacitated individual would probably like the attorney-in-fact to be able to move the principal's domicile out of a state which imposes an estate tax; but prefer that the domicile not be changed away from a no or low estate tax state. Consider the following examples:

   <u>Example 1</u>. Brenda is the duly appointed attorney-in-fact for her single 88 year-old mother, Gladys. Gladys has been a Washington resident for many years, has a substantial estate and will pay a significant amount of Washington estate tax upon her death if she remains a Washington resident. After Gladys is showing symptoms of dementia, Brenda moves Gladys to an assisted living facility near Brenda's home in Nevada. If Gladys becomes a Nevada resident following her move, no estate tax will be owed upon her death. However, if Gladys does not have the intent to make a place her home, she will not be able to establish a

domicile outside of Washington and remain a Washington resident. In this case it would be helpful if Gladys' power of attorney instrument addresses her intent with respect to domicile.

Example 2. Assume the same facts as *Example 1*, except that Brenda lives in Washington and Gladys has been a long-time Nevada resident and that Brenda moves Gladys to an assisted living facility in Washington. If Gladys becomes a Washington resident her estate will owe significant Washington estate tax; however, if she maintains her Nevada domicile, the Washington estate tax will be nominal. In this situation, Brenda would like to be able to argue that due to Gladys' incapacity, she never had the requisite intent to establish her home in Washington, and therefore never became a Washington resident. In this case, it may be better if Gladys' documents did not address her intent with respect to her domicile (or state her intent to remain domiciled in NV, irrespective of where she is receiving care).

D. **Change Form/Situs of Assets**.

1. Options for Out-of-State Residents. Because nonresidents are only subject to Washington estate tax on Washington real property or tangible personal property located in Washington at the time of their death, avoiding the Washington tax for a nonresident can be as simple as disposing of the Washington property or changing it to a form of intangible property. For example, if a nonresident transfers her Washington real estate to an LLC (even a Washington LLC) in exchange for LLC interests, she will convert her interest in Washington property (real property interest) to out-of-state property (intangible property).

   While this strategy should work in most cases, the Washington Department of Revenue has taken the position that it will only treat the interests in an entity which owns Washington property, as out-of-state property if the entity was established for valid business purposes and not merely to avoid Washington estate tax (i.e. transferring a rental property to an LLC for liability protection reasons, etc.). Accordingly, the Department may try to assert Washington estate tax is due with respect to a personal use residence located in Washington which is owned by a nonresident through an LLC, despite the fact that the nonresident only owns an LLC interest. Department personnel have acknowledged that there is no legal authority supporting its position; however, it is nonetheless a Department position, irrespective of its legal basis. There is a statute that gives the Department authority to disregard arrangements involving controlled entities to avoid the application of the sales or use tax (RCW 82.32.655), but we are unaware of any current statute or regulation that provides the same authority with respect to arrangements designed to reduce the Washington estate tax.

2. Options for Washington Residents. When structuring assets to mitigate Washington estate tax, Washington residents have limited options. As discussed above, the only assets of Washington residents not subject to the State's estate tax are: (1) real estate interests located outside of Washington; (2) and tangible personal property located outside of Washington. If a resident has excess liquid funds to invest, she may want to consider investing in these types of assets before her death. By converting intangible personal property to out-of-state real property or tangible property, a Washington resident will reduce the Washington numerator of the estate tax apportionment fraction and thereby reduce his/her overall Washington estate tax liability. Consider the following examples:

Example 1: Amy, a Washington resident, has significant real estate holdings. The majority of Amy's real estate is located in the state of Washington. Prior to her death, Amy completes a major like-kind exchange of Washington real estate for Florida real estate. Following the exchange more than half of the value of Amy's estate is comprised of Florida real estate and as a result, Amy significantly reduces her potential Washington estate tax obligation.

Example 2: Jay, a Washington resident, has significant wealth, a substantial portion of which is comprised of a valuable car collection. Prior to his death, Jay moves his car collection to his warehouse in Idaho. At the time of his death, the cars are all located in Idaho, and therefore the value of the cars is not included in the Washington numerator of the Washington estate tax apportionment fraction.

Example 3: Montgomery, a Washington resident, has significant liquid wealth and will likely be subject to Washington estate tax upon his death. Prior to death Montgomery purchases $4,000,000 worth of gold bars and stores them in a vault in an undisclosed Nevada location. Gold bars should be considered tangible personal property under Washington law (*C.W. Rhyne and Rhyne & Abraham v. Wash. Dep't of Revenue,* 1982 Wash. Tax LEXIS 2 (Wash. B.T.A. 1982)) and, therefore they should be considered out-of-state property.

As cautionary note; engaging in any transaction that clearly has no purpose other than avoiding Washington estate tax will be subject to significant scrutiny and likely challenged by taxing authorities. Accordingly, there is some risk that the Washington Department of Revenue may attempt to impose Washington estate tax on gold bars if it appears they were purchased only to avoid the tax.

*As adjusted for inflation