

RAUPC News

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Changing Chairs, Changing Tax Laws

By Bob Underhill

The election results will undoubtedly have as strong an impact on the prospect for tax legislation as any other area of the federal government. With control of both sides of Congress shifting to the Democrats, the leadership of the tax-writing committees changes. Sen. Max Baucus (MT) will now chair the Senate Finance Committee, and Rep. Charles Rangel (NY) will take over at Ways and Means. Equally important, the composition of both committees will change, with two or three Republicans dropping off the Senate Finance committee, replaced by an equal number of Democrats (the current committee is a total of 20 members). In Ways and Means, as many as nine members shift to the Democrat side (flipping the committee from 24–17 Republican to 25–16 Democrat). Apart from party affiliation, the actual membership of the committees will be further changed due to members losing re-election bids (e.g., Santorum in the Senate, Clay Shaw in the House), resigning (Foley on Ways and Means) or not standing for re-election (Bill Frist in the Senate, Ben Cardin in the House (who ran for the Senate and won). Of note for our Washington clients is that Maria Cantwell appears to be in line to join the Senate Finance Committee.

What it means

During the remainder of the Bush administration, nothing can happen that is fundamentally opposed to his tax-reduction reforms and concepts of lessening the tax burden on business and capital. The Democrats have a slim margin in the Senate, and even with the stron-

ger margin in the House, nothing that diverges greatly with Bush's tax agenda could get through his veto. Additionally, the Democrats will likely be careful not to risk heading into the next presidential election with charges that taxes were raised or new taxes proposed under their leadership. Having said that, there are several things that have relatively broad bi-partisan support that could happen:

1. The extender bill (which died this summer as part of the "trifecta" bill including estate tax reform) is viewed as likely to go through. It includes extension of the research & development tax credit, work incentive credit, above-the-line deduction of certain teaching expenses and, of particular note for Washingtonians, extension of the **deduction for state sales taxes**. Baucus is committed to pushing that in the lame duck session, although all recognize an increasingly acute practical problem: the tax forms have gone to press without incorporating those changes. That will create a fair bit of confusion for taxpayers, and undoubtedly necessitate a series of supplemental forms for taxpayers to incorporate into their returns. It also probably means a delay in final versions of tax software. The other possible approach for Congress is to pass the extenders, but not in a "seamless" fashion, i.e., no retroactivity to January 1, 2006.
2. **Alternative Minimum Tax Reform** becomes far more likely with Democrats in control. We've been subjected to "band-aid legislation" for years now, designed to keep millions more from falling into the trap of this stealth tax, but



I-920: Here We Go Again, and Again, and Yet Again

By Jay Hanson

On November 7 Washington State voters rejected Initiative 920, an initiative to repeal the Washington State Estate Tax. For the second time in 25 years Washington State voters were given an opportunity to voice their opinion on a state-level estate tax. Initiative 920 would have repealed the Washington State estate tax for decedents dying on or after December 7, 2006. However, given the overwhelming defeat of Initiative 920 it looks like the Washington State estate tax is here to stay.

Initiative 920 effectively found its way onto the November ballot after a 25-year journey. In 1981 Washington State voters approved Initiative 402 which abolished the state level estate and gift tax. However, from 1982 through 2001, Washington State was entitled to collect a small percentage of the federal estate tax imposed on Washington State decedents whose estates were required to pay federal estate tax. This so-called *pick-up tax* was included in the federal estate tax paid, and therefore did not represent an increase in the amount of federal estate taxes paid. In keeping with Initiative 402's mandate, Washington State was effectively able to collect an estate tax while not imposing its own stand-alone estate tax. However, federal tax law changes in 2001 increased the federal estate tax filing threshold and ultimately phased out the collection of the pick-up tax. The repeal of the pick-up tax effectively deprived Washington State of the revenue associated with the pick-up tax after 2004.

As a result of the manner in which Washington State law was written, the federal tax law changes in 2001 effectively triggered the imposition of a Washington State estate tax. From 2002 through 2005 the Washington State Department of Revenue began collecting state-level estate taxes. In 2005 the Washington State Supreme Court issued a ruling prohibiting the Department of Revenue from collecting this version of the estate tax and ordered refunds of past estate taxes collected. Later that same year the Washington State legislature enacted a wholly separate stand-alone estate tax. This estate tax is imposed on the value of property located within Washington

State. The threshold for the imposition of the Washington State estate tax is now \$2.0 million and tax rates range from 10% to 19%. Combined with the federal estate tax, a Washington State decedent (or non-resident with Washington situs property) could face an estate tax bill in excess of 50% of the estate's total value.

The rejection of Initiative 920 likely means that the Washington State estate tax is now a permanent feature in any estate planning discussion.

For Washington State residents, and non-residents with Washington situs property, a discussion regarding the structure of an estate plan is in order. An article addressing the impacts and planning opportunities regarding the Washington State estate tax was published in our June 2005 newsletter, a copy of which is available at our website www.raupc.com. If you would like to discuss the planning opportunities available with regard to Washington State and federal estate taxes please contact our office for further information.

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Did You Know. . .

By Rainie McLaughlin

Washington State and Federal Law requires employers to report new hires and re-hires to the Department of Social and Health Services (DSHS), Division of Child Support within 20 days of the date of hire.

The Report New Hire program aids in the collection of child support and in finding workers who are working and collecting benefits incorrectly and/or illegally. It also reduces the time it takes Child Support, Employment Security and Labor & Industries to locate the income source for employees who have moved to a new job. Decreasing the tax burden needed to fund state programs benefits our state's employers and residents.

To submit your new hire, go to www.dshs.wa.gov/newhire. You will need to provide the following:

Company Name, Address, and Federal Employer ID Number

Employee Name, Address, Social Security Number and Date of Birth

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First in a series . . .

By Bob Underhill

1. The Give-Back

Charlie is the Senior VP of Essex Corporation and, based on the company's strong earnings, receives a \$50,000 bonus at year-end. He cashes the paycheck, buys a Mercedes. The auditors arrive in February, completing their audit several months later. Unfortunately, they propose negative adjustments that wipe out half the company's income. In late April, Essex's CFO darkens Charlie's door and sheepishly says, "Guess what, Charlie, you have to give the bonus back." In the meantime, Charlie has filed his 2006 tax return, dutifully reporting the bonus. What result?

- Is the bonus still income in 2006?
- Can Charlie amend his return?
- When he pays the money back to Essex in 2007, is that a deduction?
- What if he was in a higher tax bracket in '06 (meaning the bonus cost him more in tax than he will save from taking the deduction in '07)?

Answer:

Yes, the bonus is income in 2006 under the so-called "claim of right" doctrine. However, if certain conditions are met, including a showing that Charlie *appeared at the time* to have an unrestricted right to the income, there is relief provided under Section 1341 of the Tax Code. Charlie is allowed to recompute his tax liability for 2006 as if he had reported the correct amount of income. However, the reduction in tax will not be refunded – it is allowed as a credit against future years' tax liability.

2. The Mispriced Inheritance

Jane inherits a residence from her mother's estate. The lawyers and accountants valued the home on the estate tax return at \$500,000 (and accordingly paid estate tax on that value). Recall that inherited property receives a step-up in basis to fair market value on the date of death. Jane claims that the *real* fair market value of the residence was more like \$1.5 million, which is amply borne out when she sells the property several months later for exactly that sum.

She argues with her CPA that, irrespective of what was reported on her mother's estate tax return, she is entitled to report the true fair market value as her tax basis. In the meantime, her mother's estate tax return has been reviewed and accepted as filed by the Commissioner of Internal Revenue. Does Jane get her way?

Answer:

Not if she's our client. Under the "duty of consistency" doctrine, a taxpayer owes the tax Commissioner the duty to be consistent in the tax treatment of items and will not be permitted to benefit from the taxpayer's own prior error or omission. While Jane is not the same taxpayer as her mother's estate, all but one court (on facts that were a bit more stretched) have held that closely related parties will be forced to be consistent in their tax reporting. In several cases, courts have held that an estate and its beneficiaries were "very closely aligned." But several courts have upheld the doctrine only when there are "bad acts." In this case that might be found if Jane knew that the attorneys/accountants were undervaluing the property in order to save on estate taxes.

3. Same Case, Change the Facts

Let's suppose the same facts, but that Jane accepts the reporting that the property has a \$500,000 basis through the estate. She files her 2006 return showing a \$1 million capital gain. Nine months later, the IRS audits her mother's estate and, partially based on the knowledge that Jane sold the home for substantially more money, the Service revalues the asset in her mother's estate and assesses additional estate tax of \$400,000. Does the IRS get both ends of the deal – income tax on the \$1 million capital gain from Jane, and estate tax on an additional \$1 million of value from the estate?

Answer:

Generally not. If the statute of limitations is open on Jane's 2006 income tax return when the estate tax value is finally redetermined, she can file an amended return reducing the reported gain. If her limitations period has passed, it gets more complicated. Under the doctrine of equitable recoupment, courts have allowed *the estate* to reduce future tax payments based on the tax on the excess gain reported by beneficiaries. The incidence of audit of large estates is virtually 100%, and adjustments by the IRS are not uncommon; so one might imagine that this fact situation is regularly presented. In Jane's case, she would presumably have a fair claim against the estate for the excess taxes she paid (in effect received back from the IRS by the estate).

Don't Die in Washington (And other sophisticated planning ideas)

By Bob Underhill

As our clients in Washington know all too well by now, the initiative to repeal Washington's "death tax" was defeated. Last-minute political ads hammered home the message that this was a "soak the rich" tax, which would apply to only a few hundred ultra-wealthy families a year. Playing a cherished American theme (and to assure that western Washingtonians went along), family farms are exempted (but what about family businesses?). And to put unassailable icing on the political cake, the tax revenues are devoted to schools and education (although we probably need roads even more).

It should not be surprising that 6.5 million voters, once they understood the message, would vote OK to taxing a few hundred other people. It strikes us as borderline taxation without representation. Most people don't have a problem taxing other people.

You can debate the social policy reasons for a death tax, but there's no debating the near unconscionable size of the rates: after a \$4 million exemption, Washington levies a 10% tax on the next \$10 million of wealth and **19% thereafter**. We have the distinction of the highest death tax in the nation.

We also question the Department of Revenue estimates that the tax will only apply to several hundred decedents a year (due to exempting the first \$4 million of a family's wealth). It seems to us that even a tear-down house on Puget Sound or Lake Washington waterfront is worth that much. Then consider all the family-owned businesses in the state, as well as the technology wealth created here in the '90s (perhaps the tax demographers understand that most of the tech millionaires are only in their 40s and won't be dying anytime soon). Remember, like the federal estate and gift tax, it's the *value* of assets passed that's taxed, not what you paid for them.

The word around the estate planning community is that wealthy people will "vote with their feet." You're only taxed if you are a resident of Washington on the date of death. While you generally can't pick a date to die, many people later in life who come closer to facing this tax on their family may choose to move. An optimal strategy would be to live here in an income tax-free environment, and move later on to an estate tax-free environment. Transfers to surviving spouses are exempt, so in effect, only the survivor needs to move. Our expectation is that very few people will pick up and move now—paying state income

taxes in Arizona, California, Oregon, etc. is no fun either, and that happens every year.

It's interesting to observe that many wealthy families have second residences in the desert, Hawaii, Idaho and elsewhere. The death tax is imposed on Washington residents, but residency can be a nebulous thing, especially for couples with more than one place of abode. So for many, it might not take a move at all—just spending a little bit more time in Scottsdale or Maui will do. Again, the strategy is not now (you don't want to pay Arizona or Hawaii income tax in the meantime)—but later. There are multiple factors used to determine residency—where you vote, where your cars are licensed, where your kids are in school, where your principal medical, professional and financial relationships are maintained—but the biggest factor is where you spend the most time. And be careful not to trip the balance too soon. Most of our Washington clients are unfamiliar with how state income taxes work. If your state of residency has an income tax, **it taxes 100% of your income** (with a credit for taxes imposed by another state). In other words, it is not apportioned or allocated.

Reno, NV is looking pretty good (no income tax, no death tax).

Okay, if you die domiciled in Washington, what's subject to tax? Generally speaking, all real estate and tangible property located in Washington is taxed. So if you are the deeded owner of a condominium in Scottsdale, the condo and its contents cannot be taxed by Washington State on your death. But let's reverse the facts: suppose you are residing in Scottsdale at the time of your death, but continue to own real property in the Seattle area. Washington will tax that, even though you live out of state (that will surprise a few families around the country who are unfamiliar with our laws and happen to own property here).

The tax is also imposed on the value of any intangible assets owned at death by Washington residents. That obviously includes stocks and bonds, but it is important to note that it also includes assets held in living trusts as well as interests in businesses or property owned in corporations, partnerships and LLCs. Here, people could unwittingly shoot themselves in the foot. Suppose a Washington resident owns a condominium in Scottsdale, but desires to rent it out on occasion.



Supersizing Tuition Gifts

By Jay Hanson

The IRS has recently decided that the pre-payment of tuition in certain circumstances will not be treated as a taxable gift for either gift tax or generation-skipping transfer tax purposes. In a case before the IRS, the donor had six grandchildren and wanted to pay school tuition for all six grandchildren until their respective graduation dates. The donor agreed to pre-pay the full tuition amount for each student directly to the school where the child was to attend based on an agreement that the payments would be non-refundable and be subject to increases later to be paid by the donor or the student's parents. The agreement also stipulated that the students would not be guaranteed enrollment nor given any privileges as a result of the tuition pre-payment. The IRS agreed with the structure of this transaction and determined that the tuition pre-payments were not subject to gift tax.

Given this holding by the IRS in this case, a donor is now effectively able to make what is the equivalent of multiple gifts of tuition without being limited to the \$12,000 annual gift tax exclusion or needing to utilize any portion of the donor's lifetime gift tax or generation-skipping transfer tax exemption. For this type of gifting to escape gift tax, the gift of pre-paid tuition must be made to a qualified educational institution which normally maintains a regular faculty and curriculum and has a regularly enrolled student body where the educational activities take place. The tuition can be for students enrolled in kindergarten through graduate or professional school and can be applied to either full- or part-time students. However, the tuition pre-payment must be forfeitable if the student leaves the school or is otherwise unable to enroll after the transfer. Additionally, the tuition pre-payment must be for amounts paid as tuition costs which are paid directly to the qualified educational institution.

To illustrate this gifting strategy, we will assume Grandmother wants to help her Granddaughter attend a local private high school which Granddaughter's family would otherwise not be able to afford. Granddaughter will be enrolled as a first-year student this fall and the private high school Grandmother has in mind normally maintains a regular faculty and curriculum and has a regularly enrolled student body where the educational activities take place. To enable Granddaughter to attend this private high school Grandmother makes a single \$50,000 tuition payment directly to the private high school in an amount equal to four years' worth of tuition on behalf of Granddaughter. Grandmother agrees that this pre-payment of the tuition is nonrefundable and

that Granddaughter will receive no privileges because of the pre-payment of the tuition. Because the non-refundable, no-strings-attached pre-payment of tuition is being made to a qualified educational institution, the payment is completely exempt from both gift tax and generation-skipping transfer tax.

If you have any questions regarding this gifting strategy or have inquiries regarding any other tax planning matters please contact our office for more information or assistance.

CS

The Perfect Storm: Rising Interest Rates, Rising Real Estate Appreciation and the QPRT

By Jay Hanson

It is well documented that the regional real estate market has seen some very strong appreciation rates over the past several years. While this is a boon to property owners, we pause to put this rapid appreciation into context for estate planning purposes. Rapidly increasing real property values may indeed increase an individual's net worth, but such increases may ultimately translate into an increase in both the federal and Washington State estate taxes. The rapid appreciation of real property has tended to enlarge the value of many estates for estate tax purposes. Many homeowners who desire to pass appreciating residential property to their children and at the same time save federal (and potentially state) estate taxes and minimize federal gift taxes have utilized what is known as a qualified personal residence trust (or QPRT).

A QPRT is an IRS-approved estate planning vehicle used to transfer a personal residence from one individual to another to help alleviate the estate taxation associated with the value of such property. The transfer of the residence to the QPRT also has the added value of achieving a reduced gift tax valuation at the time of transfer (see below). The transfer of property via a QPRT is generally made from parents to children and the family home or vacation residence is often the property selected for transfer. The QPRT is essentially a trust which allows a homeowner to make a future gift of residential property while retaining for the homeowner the right to continue to reside in the home for a defined number of years. In a typical QPRT arrangement, the homeowner transfers title in the residence to a trust for a set number of years. During this term of years, the homeowner retains the right to live in the home just as the homeowner would have done prior to the transfer. At the end of the trust's term

A donor is now effectively able to make what is the equivalent of multiple gifts of tuition without being limited to the \$12,000 annual gift tax exclusion or needing to utilize any portion of the donor's lifetime gift tax or generation-skipping transfer tax exemption.

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even the band-aids aren't keeping that from happening. The Republicans had opted for an agenda that included lower taxes on dividends and capital gains (which actually exacerbates the AMT problem) and estate tax repeal. True reform of the AMT, to get it to do what Congress originally intended it to do—that is, impose a supplemental tax on individuals and corporations who heavily shelter their income—will cost billions. Unfortunately, there isn't enough money for all of it. But many states with very high state income taxes (which also trips people into the AMT due to the non-deductibility of state taxes under the AMT system) are "blue states". Powerful Democrats from California (Feinstein, Pelosi), Oregon (Wyden), New York (Clinton, Rangel), Massachusetts (Frank) and elsewhere have AMT reform as a leading issue.

- The fundamental problem is how to pay for it. The tax is hitting so many people that reforming it effectively forces tax increases somewhere else under the "pay-as-you-go" budget neutrality rules.

On the longer horizon, Rangel is on record as not happy with the **15% "tax break" on dividends and capital gains**. He has also gone public, however, as not wanting to pull back the cuts, which Congress recently extended through 2010. But the way tax law is often written today, Congress needs do nothing to make the cuts go away. They simply expire in 2010, and in the world of politics, they haven't done anything to increase your tax. To pay the price tag of AMT reform, the 15% rates on investment income will be in jeopardy.

To give perspective, the top tax rate on dividends in 1985 was 70%; the top rate on long-term capital gains was 35%. Excepting Washington and a few other states, state income tax took another bite. No one is suggesting that tax rates will go that high again—we all recognize that people will do very unconventional and unproductive things with their money to shelter it from tax rates that high. And studies have confirmed that lower rates do, in fact, stimulate capital formation

and economic activity. But returning the capital gain rate to 20%, and the rate on dividends to the ordinary 35%, seems reasonable in comparison (and therefore, entirely possible).

Estate Tax Reform is not dead. The absurd way the law is written now, with complete repeal in 2010, followed by restoration of the system with rates and exemptions retroactive to 2001, virtually assures Congressional attention. That attention is now on the Democrats' watch. What this probably means is that a total repeal of the system is highly unlikely (remember, it almost happened last year—the repeal bill cleared the House and narrowly failed the Senate, post-Hurricane Katrina). The professional community views the most likely scenario as a lowering of rates to perhaps 35%, or to the capital gain rate (which could increase per the discussion above), and raising exemptions to \$3.5-\$5 million. While the estate and gift tax is not a significant revenue raiser, it does chip in something, and Democrats view a tax on the transfer of large family wealth as legitimate social policy.

Other legislative attention promised by Baucus and Rangel include:

- Protection for low-income taxpayers and legislation designed to protect US jobs.
- Tax relief targeting small business.

- Codification of the "economic substance doctrine," a common law (court developed) concept underpinning the Internal Revenue Code which is designed to tax a series of interrelated steps, transactions or events consistent with the overall economic result. However, some, including the IRS, feel that courts are better able to forge a tax result consistent with the

true economics of a transaction, as opposed to greater reliance on the "harder edges" of a statute.

- Bills to narrow the so-called "tax gap" (the difference between taxes legally owed and what is actually collected). This might include some simplification (meaning repealing certain deductions); greater reporting responsibilities of payors and financial institutions (e.g., reporting of *gains* on sales of securities, as opposed to *proceeds*, requiring securities firms to track tax basis); and greater enforcement (i.e., more IRS agents).

True reform of the AMT, to get it to do what Congress originally intended it to do—that is, impose a supplemental tax on individuals and corporations who heavily shelter their income—will cost billions.

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4. A Convenient Exchange

Company A and B are controlled by the same family. A owns a widget plant in Washington with a value of \$10 million and a (depreciated) tax basis of \$9 million. B owns an older plant in Oregon with a value of \$10 million and a basis of \$1 million. To consolidate operations the family decides to sell the Oregon plant and operate with the (newer) Washington plant. Their accountant advises them that selling the Oregon plant will trigger a \$9 million gain, taxed at 35% (federal) plus 6% (state). The thought of paying over \$3.6 million in combined taxes horrifies them. The CPA has a plan: companies A and B will swap plants in a Section 1031 "like-kind" exchange. Under the exchange rules, the gain is deferred, and company A will take the Oregon plant with a carryover tax basis of \$9 million. Company B will take the Washington plant (the keeper) and carry over its tax basis of \$1 million (in effect, a basis swap). Company A puts the Oregon plant on the market and completes a sale for \$10 million (to a third party) several months later. A computes its gain as \$1 million (the difference between the proceeds and its \$9 million carryover basis in the like-kind exchange). Great planning or tax fraud?

Answer:

The family's CPA is a little out of date (by about 20 years). This used to work. One might imagine that Congress wasn't too fond of it, and until Section 1031(f) was put into the law, a lot of it went on. Section 1031(f) says that if related taxpayers enter into a like-kind exchange, and either party disposes of the exchange asset within a two-year period, the exchange is retroactively busted and the original exchange is fully taxable (to both sides). Even beyond two years, the taxpayers cannot have a prearranged plan to dispose of one of the assets. If the two-year requirement is met, and if the original exchange had a non-tax purpose, the basis swap will work.

It is interesting to note that Washington clients with Oregon or California real estate who do a "northbound" 1031 exchange (into Washington—or Nevada—property) will also succeed in moving their built-in gain out of the Oregon or California taxing jurisdictions. Remember: like-kind exchanges can only be done with business or rental property (not inventory, securities or personal use property).

5. A Creditor Protection Trust in a Tax Haven

Many wealthy individuals have some concern about asset protection and creditor risk, due perhaps to the business they're in, or even the driving habits of dependent children. Tony has

heard of too many horror stories and wants total financial security and peace of mind. After attending a Bellevue Hilton seminar one evening on asset protection trusts, he decides to act. Through local advisors, he is introduced by phone to a law firm in the Isle of Man. Weeks later he is flying to London to conduct interviews and discuss legal steps. A trust is created with an Isle of Man corporate trustee (the absence of a treaty prevents US courts from exercising jurisdiction or control over the Isle of Man trustee). The trust is carefully drawn to direct the trustee to deny distributions in the event that Tony, the beneficiary, is under any financial or legal duress. Tony liquidates \$10 million of US securities and wires the proceeds to the trustee, thereby funding the trust. Hearing that the Isle of Man is a tax haven, he assumes that the money in the trust will escape US income tax until distributed. In this fashion, he can "park" income in the trust, building an even greater protected nest egg. In the first year, the trust earns \$500k in income and gains, none of which is distributed. The tax rate in the Isle of Man is 1%. How will it be taxed?

Answer:

Most people know (at least instinctively) that the US takes a global view to taxation. A citizen or resident person is taxed on worldwide income. Tony is both the settler of the trust and a beneficiary of the trust. Consequently, even though the trust is irrevocable and he has forfeited all control over the assets to the foreign trustee, it is treated as a grantor trust. All income and gains must be reported directly by him on his 1040 (with a potential foreign tax credit for any taxes paid on the same income to the Isle of Man).

Interestingly, on Tony's death, it's no longer a grantor trust. Assume that the trust continues in existence for the benefit of his children. At that point, we have a beautiful thing. Income will be taxed to the beneficiaries only when distributed, meaning that it can accumulate in the trust at the low tax rates in the tax haven country.

6. What About a Foreign Corporation?

If a foreign trust won't work to defer income, what about forming a foreign corporation? Assume instead that Tony transfers the \$10 million to a Cayman Island corporation, 99% owned by him, with an unrelated Cayman Island company contributing \$1,000 for a 1% interest. Tony then transfers his shares to the Isle of Man trust. The funds are invested in non-US securities and generate \$500k in income and gains. The Cayman Islands tax rate is zero. Since the income is earned by a corporation (not a pass-through entity like a trust or partnership), will income earned by the corporation escape US tax until distributed?

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Since that involves strangers paying to use the property, one's initial reaction might be to place the property in an LLC for creditor and liability protection. But that ends up being a bad mistake from a Washington estate tax standpoint – owning the property outright excludes it from our death tax; owning it through an LLC converts it into “intangible property,” thereby hitting it with tax of up to 19% of its value.

What backfires for Washingtonians turns out to be precisely the right thing to do for non-residents who own real estate here. If a California resident owns property in the San Juans, conveyance to an LLC converts it from a Washington real estate interest subject to our death tax to an intangible asset (Washington cannot tax intangibles owned by non-residents, even if the underlying property is here—not yet, anyway).

For Washingtonians, while not much creditor protection is offered, the best way to own out-of-state real estate is still through a living trust. Use of a living trust also avoids probate administration (and cost) in the other state. In recent years, some have used LLCs to own out-of-state real estate for both creditor protection and probate avoidance, but as discussed above, that will actually pull the property back into the Washington tax regime.

Since Washington has no gift tax, another area of planning involves making lifetime gifts (even deathbed transfers) in order to drive down the value of one's estate. Making gifts in excess of the lifetime exemption amount is something we don't often see (clients generally don't like paying gift tax. But due to the way in which the federal gift tax and estate tax are computed, it is more efficient to make lifetime gifts. An example will help:

Assume Mary is willing to transfer her estate of \$1 million and is in the 40% estate and gift tax bracket. If Mary dies and passes her estate at death, the estate tax will be \$400,000 (40% of her taxable estate), leaving her heirs with \$600,000. If Mary instead makes lifetime gifts of her entire wealth, her heirs will end up taking \$715,000, on which there will be a gift tax of \$285,000 (40% of the gifted amount). Add in the savings of Washington estate tax, and it is quite compelling. If Mary passed her assets at death, the combined federal and state death tax would be \$514,000, leaving the heirs only \$486,000 (\$229,000 less than the gift scenario).

Of course the other advantage of lifetime gifting is that all future income and appreciation is also removed from one's estate.

The principal disadvantages of making lifetime gifts are, obviously, loss of income and control. From a tax standpoint, you lose the step-up in basis otherwise pertaining to property transferred at death, so it is wise to transfer high-basis property. Since the basis of gifted property carries over to the donee, that is also smart from an income tax standpoint; otherwise, the donee gets tagged with the capital gain tax on sale (which effectively nets down the value of the gift).

Many people will consider revising durable financial powers of attorney to give power and latitude to appointees to make gifts in the event there is a period of incompetency preceding death. Absent such powers, it would be difficult or impossible to engage in any effective estate tax planning under the circumstances of mental incompetency. The appointee would logically be one's spouse or family member; however, there are complicated issues involved. The common law does not allow an attorney-in-fact to make gifts on behalf of the principal, and this concept has been retained in the statutes. The Washington Code prohibits an attorney-in-fact from self-appointing (making gifts to him or herself), except for his or her maintenance, education, support and health. More general gifting will require appointment of an independent, non-adverse party. Due to the sensitivity of the process and to guard against being questioned or second-guessed by other heirs, many independent power holders want indemnification and exculpatory protection.

Finally, it is important to note that the Washington tax does not include a generation-skipping provision. Consequently, transfers to second- or third-generation heirs are beneficial, certainly to the extent of the federal GST exemptions.

CG

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Answer:

That won't work either. Subpart F came into the tax code in 1961 (subpart F of Subchapter C). If a foreign corporation is controlled by US persons (50% or more by vote or value), and if the foreign corporation generates certain types of income, that income will be taxed currently to the US shareholders (in effect, treating the corporation similar to an S corporation—where earnings pass through). Several of the proscribed types of income are personal holding company income (interest, dividends, rents, annuities, etc.) and foreign base company sales income (buying goods from a related US person and selling to any person, or buying goods from any person and selling to a related US person).

CG

QPRT Continued from page 5

the trust property is distributed out to the trust's beneficiaries and the beneficiaries own the property at that time. This type of transfer effectively removes the residence from the homeowner's estate if the homeowner survives the trust's termination date. If the now-former homeowner wishes to continue to live in or use the residence after the termination of the trust's term, then the former homeowner must arrange to lease the property from the trust beneficiaries at a fair market value rent. The payment of rent at the termination of the trust also has the advantage of removing additional assets from the former homeowner's estate without any gift tax consequences.

The minimization of transfer taxes is generally a strong incentive for creating a QPRT and the prevailing federal interest rate is a very important factor in determining the overall tax savings. The higher the federal interest rate, the higher the QPRT's potential tax savings. Conversely, the lower the federal interest rate the lower the tax savings. For gift tax purposes, the entire interest in the residence is deemed to be transferred but the transfer value is determined using a discount which is calculated in large part from the prevailing federal interest rate. This generally results in a gift valuation which is only a fraction of the residence's actual fair market value. The actual value of the gift (and the gift tax savings) is dependent upon the donor's age, the length of the QPRT's term and the prevailing federal interest rate at the time of the transfer. Generally speaking, the longer the QPRT term, the lower the gift tax transfer value. Additionally, subsequent to the transfer of the residence to the QPRT the value of the residence is locked in and any appreciation in the value of the residence is not subject to gift tax or estate tax if the transferor survives the trust's term.

To illustrate the potential transfer tax savings a QPRT can deliver, we will assume a transferor is interested in transferring her vacation cabin which is currently worth \$1,000,000 to her two children. The transferor is 55 years of age and wishes to keep the property an additional 15 years. Placing the property into a QPRT will allow the transferor to keep the property until the transferor reaches age 70, at which point the property will then pass from the QPRT to her two children. The initial transfer of the property to the QPRT will result in a taxable gift equal to \$332,000 of the property's total value. Assuming a 5% annual growth rate of the property over the QPRT's 15-year term, the fair market value of the property at the termination of the QPRT will be slightly in excess of \$2,000,000. If the transferor survives the 15-year term the donor will have successfully

removed over \$2,000,000 in assets from her estate, thereby saving up to \$820,000 in federal gift taxes. This transfer tax savings was bought at the cost of making a \$332,000 gift, which represents a fraction of the property's fair market value at the time of the gift. The transferor is permitted to offset the \$332,000 gift with an equal amount of her remaining \$1,000,000 lifetime gift tax exemption.

The mechanics of a QPRT are much more involved than can be put into words in this short article and we are available to discuss the potential benefits and burdens a QPRT may have in regards to your particular circumstances. Please contact our office for more information regarding this planning technique.

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Amy's Space Filler: Random Facts from Wikipedia

By Amy Bockelman

For the easily amused, here's something even more random than my iPod article! I often turn to the Internet when I can't think of an idea for a humorous article, and instead end up with something random and occasionally interesting. Repeatedly clicking on the "Random article" link on the Wikipedia site for about a half-hour yielded the following facts heretofore unknown to me:

- The Isle of Man has three RAF (Royal Air Force) stations.
- Jacky Ickx won the Formula one 1970 Austrian Grand Prix.
- Dmitri Shostakovich's last quartet, String Quartet No. 15 in E flat minor, was completed on May 17, 1974.
- Sedimentary rocks are formed by a process known as lithification.
- The first American vessel lost in World War I was the USS Alcedo (SP-166), a yacht in the U.S. Navy.
- The town of Lyndon in Sheboygan County, Wisconsin, had a population of 1,468 at the 2000 census.
- William Yates Atkinson, who was governor of Georgia from 1894 to 1898, vetoed a law that would have prohibited football in the state AND he hired the first female salaried employee in state government.
- Wikipedia has an entry for "Inward-rectifier potassium ion channel." There's no space in this column to explain what that means (even if I knew), but evidently it has something to do with biochemistry and disease.
- The asteroid 4486 Mithra has two distinct lobes and is apparently the most highly bifurcated object in the solar system.

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*Generally speaking,
the longer the QPRT
term, the lower the gift
tax transfer value.*

Tax Events Calendar

Date	Taxpayer	Event
December 15, 2006	Corporations	Fourth installment of 2006 estimated income tax by corporations is due (use Form 1120-W to determine estimated tax liability).
January 15, 2007	Individuals	Final installment of prior-year estimated tax by individuals is due, unless an income tax return is filed and tax paid in full by January 31, 2007.
January 31, 2007	Employers	Employees' statements of amounts withheld in 2006 (Form W-2 or 1099R) must be furnished by employer.
March 15, 2007	Corporations	Last day for a calendar-year corporation to elect S corporation status beginning with current tax year (file Form 2553).
March 15, 2007	Corporations	Last day for calendar-year domestic corporations or foreign corporations with offices in the U.S. to file prior-year income tax return (Form 1120 series). File form 7004, together with payment, to obtain an automatic six-month extension of time to file.

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