

## State and Federal Death Taxes

The federal death tax is a one-time tax to be paid by the estate of a decedent, based on the combined value of all assets in the estate. Most states have a comparable state version of the death tax as well. The rules concerning state and federal death taxes are voluminous and complex but they all boil down to this: whatever assets you own at death are subject to a tax, unless there is an exemption available.

### Tax Rates and Exemptions

Federal estate taxes are payable by most estates having a gross value of over \$3.5 million, or \$7 million for married couples under current law. The corresponding threshold amount for Oregon inheritance taxes is currently \$1 million per decedent. For estate tax purposes, your estate generally consists of all of your assets, including home equity, investments, life insurance proceeds, retirement funds, inheritances, vehicles, and other personal property. You should carefully consider whether your combined estate is over the state or federal exemption amount. If so, your estate could be subject to substantial state and federal death taxes if something happened to both you and your spouse. There are several estate planning techniques to minimize or completely eliminate such taxes.

The consequences of neglecting estate planning can be significant, since the federal estate tax rate is now 45% and will increase to a top rate of 55% in 2011, under current law. Thus, if your estate is subject to federal estate taxes, those taxes will be at least 45% of the taxable portion of your estate. The rates for Oregon inheritance tax range between 5.6% and 16%, but the rate is 41% of the first \$93,785 over the \$1 million threshold amount. Thus, an estate of \$1,093,785 pays Oregon inheritance tax of \$38,451.85. All death taxes must be paid within nine (9) months after the date of death.

There is an important tax rule known as the marital deduction, by which any amount of assets can pass from a decedent to the surviving spouse free of state and federal death taxes on the death of the first spouse to die. However, upon the death of the second spouse to die, there is no marital deduction, and substantial taxes are often due.

Under current law, the federal estate tax exemption will return to \$1 million in the year 2011. If this law is not changed, your estate may owe even more federal estate taxes. Most estate plans provide for such taxes, if any, to be paid from the residue of your estate, effectively charging all taxes and administrative expenses against the assets allocated to your children (assuming they are the residual beneficiaries). If any significant assets are left to other beneficiaries, you should consider charging the death taxes attributable to such assets, to the beneficiaries receiving them. This is often referred to as tax apportionment.

## QTIP Provisions

The marital deduction, mentioned above, is available only for property passing from the deceased spouse to the surviving spouse outright, with no “strings” attached. An exception to this rule allows certain restrictions to be placed on property passing to the surviving spouse, and yet still qualify for the marital deduction. Such property is called Qualified Terminable Interest Property (QTIP).

To qualify as QTIP property, the surviving spouse must receive the income from such property for life, paid in quarterly or more frequent installments. Typically, your Will or Living trust would provide that the QTIP property must be held in a trust for the benefit of the surviving spouse, and would also give the surviving spouse the power to invade the principal, if necessary for emergencies, etc. Most importantly, your Will or Living trust would mandate that the QTIP assets pass to your children after the death of your spouse. In this way, you can ensure assets will pass to certain beneficiaries (i.e., child from a prior marriage) without interference. These are the most typical “strings” allowed by the IRS.

For any or all of the QTIP property, your trustee has the power to choose, during the nine-month period after death, between (i) allowing the QTIP property or any portion of it to be taxed in your estate, or (ii) making the QTIP election for such property, causing it to be taxed in the estate of the surviving spouse. This creates greater flexibility by allowing a “second look” at the projected death taxes following the death of the first spouse to die. In many cases, it is preferable to postpone the payment of state and federal taxes, and the QTIP election effectively allows this.

It is anticipated that the QTIP election would be made, if at all, for assets passing to the spouse with the above “strings” attached. The QTIP election would also be made, for state inheritance tax purposes only, for assets in the QTIP Trust which exceed the state death tax exemption, currently \$1 million per person.

## Lifetime Gifting

Gifting is sometimes used to “thin down” an estate which would otherwise be subject to death taxes. However, there is a separate tax on amounts that are gifted, called federal gift tax. The gift tax rate is the same as death taxes: 45% under current law. There is also a federal gift tax exemption allowing gifts of \$13,000 per year per recipient, under current law. Gifts in excess of this limit are generally subject to the federal gift tax, though there is no comparable state gift tax. The federal gift tax applies to all gifts of any value, if the cumulative value of the gifts to one person exceeds \$13,000 per year. If a larger gift is made and would otherwise be taxable, you may elect to use part of your lifetime exemption from federal estate tax (currently \$3.5 million per person) to exempt such gift from gift tax. However, there is a limit on your use of the lifetime exemption for gifts. This limit allows only cumulative gifts of up to \$1 million to be exempt from gift tax. Gifting can be an effective means of reducing the size of an estate which may be potentially subject to estate taxes at death. In addition to immediately reducing the value of your taxable estate, gifting will shift all future appreciation of the gifted

property out of your estate for estate tax purposes. Of course, many individuals are reluctant to make such gifts, since gifts must be irrevocable and are therefore inflexible.

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