2015 Oregon Forest Tax Symposium

Forestry Succession Planning in Oregon: Addressing Oregon Income and Estate Tax Consequences[1]

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I. Overview.

Transferring wealth from one generation to the next is not a one-size fits all endeavor. Successful plans need to take into account not only the income and estate tax consequences of the transfers, but also the emotional, physical, and psychological needs and objectives of the individuals involved. The plan must be flexible enough to adjust to future changes in the law and family circumstances, but not too flexible that the donor's intent is easily compromised. These non-tax concerns are very important for the individuals involved in traditional agricultural and forestland related enterprises because the property has frequently been in the family for several generations who have poured their blood, sweat, and tears into the operation. They want to pass the operation on to their children, as their parents did before them. Unfortunately, as society has changed and people have moved away from the forestland property, finding a suitable heir to hand the reins to, while also providing for the other children who are not as involved, can be a difficult challenge.

As the advisors, it is our responsibility to identify the individual needs and desires of our clients and apply the relevant laws as tools to help them achieve their goals. As with most things, an effective and comprehensive plan does not occur overnight and frequently needs many years to be fully implemented. Understanding the current tax structure is a must in order to design and apply a plan that will not only be successful but also rewarding for clients.

II. The Oregon Estate Tax Picture

A. Federal and Oregon Estate Tax Exemptions and Rates - Not the same:

1. 2015 Federal Estate Tax Exemption: $5,430,000 (indexed for inflation)
2. Oregon Estate Tax Exemption: $1,000,000 (not indexed for inflation)
3. Gap between Oregon and Federal exemptions: $4,430,000
4. Federal Estate Tax Rate: 40%
5. Oregon Estate Tax Rates: 10% beginning at $1 million rising to 16% at $9.5 million

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B. When Does an OR Form 706 Need to Be Filed?

1. **First – Determine Value of Decedent's Gross Estate.** Identify and determine the value of "all property, real or personal, tangible or intangible, wherever situated." (Worldwide assets) IRC §2031(a) and ORS 118.005(6) [2].

2. **Second—Determine Whether an Oregon Estate Tax Return Is Required.** If the value of the decedent's worldwide gross estate is less than $1,000,000, then no Oregon estate tax return is required to be filed. ORS 118.160(1)(c). However, because the decedent's gross estate includes the value of all of the decedent's assets, wherever located in the world, a resident or nonresident decedent whose gross estate value exceeds $1,000,000 and includes assets located in Oregon worth less than $1,000,000 will still be subject to the OR706 filing requirement.

3. **Third – Determine The Overall Oregon Estate Tax** – *See* Table #1:

Table #1		
Current Oregon ESTATE Tax		
At Least	Base Tax	Rate
1,000,000	0	10.00%
1,500,000	50,000	10.25%
2,500,000	152,500	10.50%
3,500,000	257,500	11.00%
4,500,000	367,500	11.50%
5,500,000	482,500	12.00%
6,500,000	602,500	13.00%
7,500,000	732,500	14.00%
8,500,000	872,500	15.00%
9,500,000	1,022,500	16.00%

4. **Determine the Actual Oregon Estate Tax (Oregon Fraction)** – *See* Table #2:

Table #2	
The Oregon ESTATE Tax Fraction	
Gross Estate	$2,000,000
Gross Value of Property In Oregon	$ 999,000
Oregon Percentage	49.95%
Oregon Estate Tax Calculation	$ 101,250
Tax Payable to Oregon	$ 50,574

5. **When is the Oregon Estate Tax Due?** The OR706 Estate Tax Return is due nine months after the date of the decedent's death unless an extension has

[2] NOTE: Oregon estate tax statutes reference the federal estate tax law as that law existed as of December 31, 2010 (ORS 118.007).

been obtained. A six-month automatic extension to file an OR706 return is available if filed within nine months after the date of the decedent's death.

6. **When is the Oregon Estate Tax Return Due?** The Oregon estate tax is also due nine months after the date of the decedent's death. ORS 118.100(1) and 118.160(1)(c).

   a. **Extension of Time to Pay:** An extension to pay the tax is available for up to 14 years at the discretion of the ODR, provided the extension application is filed within nine months after the date of the decedent's death. ORS 118.225

   b. **Current interest rate:** 4% per annum and taxpayer must provide adequate security to the Oregon Department of Revenue for the unpaid tax**.**

C. **<u>Problem with Lifetime Gifts – No income tax basis increase</u>**

1. **<u>Transfers at Death</u>**: When an heir receives property from the estate of a decedent, the income tax basis adjusts to an amount equal to the property value as of the date of death.

   a. **<u>Appreciated Property</u>**: Income tax basis <u>increases</u> to fair market value as of the date of death.

   b. **<u>Depreciated Property</u>**: Income tax basis <u>decreases</u> to fair market value as of the date of death.

   c. **<u>Income Tax Result</u>**: Generally, no gain or loss if property sold for an amount equal to the date of death value.

2. **<u>Lifetime Gifts:</u>** Recipient of gift receives the donor's income tax basis.

   a. **<u>Appreciated Property</u>**: No income tax basis adjustment – can be significant income taxes when property is sold.

   b. **<u>Depreciated Property</u>**: No income tax basis adjustment, but generally cannot take loss when tax basis exceeds selling price.

   c. **<u>Federal Estate Tax Savings: for individuals with asset value less than $5.43 million</u>:** No estate tax savings if no federal estate tax due.

   d. **<u>Compare Oregon Estate Tax Savings with Potential Income Tax Cost:</u>**

      i. **<u>Oregon Estate Tax:</u>** 10% to 16%

      ii. **<u>Income Tax Cost:</u>** Combined State Income and Federal Capital Gains tax – 24% to 32.8%

D. <u>Married Couples</u>

1. **<u>When the first spouse dies how does a couple defer the Oregon Estate Tax on the $4.43 million Gap between the Federal and Oregon Exemption?</u>**

   a. Transfer property to surviving spouse.

   b. Oregon Qualified Terminal Interest Property ("QTIP").

   c. Oregon Special Marital Property (OSMP).

2. **<u>Portability Election in Oregon?</u>**

   a. Oregon has no portability election.

   b. Federal Portability. Under the American Taxpayer Relief Act of 2012 ("ATRA") the spousal portability provision under the federal estate tax law was made permanent. As a result, the surviving spouse can elect to combine the deceased spouse's unused exclusion amount ("DSUE") with his or her own applicable exclusion amount. IRC 2010(c).

   c. Example. Assuming that the husband was the first spouse to die and that he died in 2015 and made no gifts during his lifetime that would require the filing of any Form 709 gift tax returns, his DSUE could be as much as $5,430,000. With a portability election, the surviving spouse can increase her total applicable exclusion amount to $10,860,000.

   d. Making the Election. In order to make the portability election a Form 706 federal estate tax return must be filed in a timely manner even though no federal estate tax is due and even if a federal estate tax return is not required. The initial filing deadline is nine months following the date of death. If a timely extension application is filed within nine months following the date of death, the time for filing a Form 706 federal estate tax return and making the portability election can be automatically extended for an additional six months.

III. <u>Oregon's Natural Resource Credit (NRC)</u>

A. <u>Value Requirements:</u>

1. **Adjusted Gross Estate does not exceed $15 million;**
2. **Value of Natural Resource Property ("NRC") the <u>claimed</u> amount cannot exceed $7.5 million, so NRC property values can exceed $7.5 million but no more than $7.5 million can be claimed;**
3. **Value of natural resource property must be at least 50% of the total adjusted estate.**

B. <u>Family Use Requirements</u>:

1. **<u>By Decedent</u>**: For five out of eight years ending on the decedent's date of death decedent or family member must have operated the forestry business.
2. **<u>NRC Property Transferred to Family Member</u>**: must use for at least five out of eight years following the decedent's death.
3. **<u>Family Member</u>:** An ancestor of the decedent, a spouse of the decedent, a lineal descendant of such individual, or of such individual's spouse, or of a parent of such individual, or the spouse of any lineal descendant.
    a. **<u>Net Cash Lease</u>**: To or from the decedent or family member qualifies.
    b. **<u>Property Held in Trust</u>:** If a family member is a beneficiary qualifies and the trustee is a family member who materially participates in the forest business, the trust will qualify.
4. **<u>NRC Property Held in Entities</u>:** NRC property owned indirectly by the decedent or family member in limited liability company, corporation, partnership, or trust qualifies if:
    a. **<u>At least one family member must materially participate in the forest business.</u>**

C. <u>Natural Resource Property Requirements</u>

1. **<u>"Natural resource property"</u>** means property, if on the date of the decedent's death the property is owned by the decedent and used in the operation of a farm business, forestry business or fishing business owned by the decedent.
2. **<u>"Forestry business"</u>** means a business operated for the primary purpose of obtaining a profit in money by the planting, cultivating, caring for, preparing, harvesting or cutting of timber or trees for market.
3. **<u>Eligible Property</u>**:
    a. **<u>Real Property</u>**: Real property in this state used as forestland or as forestland homesites, not to exceed 5,000 acres.
        i. ORS 307.010: Includes land, buildings, structures, machinery affixed to the land, mineral rights, water rights and standing timber.
    b. **<u>Forestland</u>:** Western Oregon Forestland (ORS 321.257) and Eastern Oregon Forestland (ORS 321.805).
    c. **<u>Homesite</u>**: Dwelling on property designated as forestland (ORS 308A.250).
    d. **<u>Timber or Trees</u>**: Real property or personal property.

e. **<u>Forestry Business Equipment</u>**

f. **<u>Operating Allowance</u>**: Lesser of $1 million or 15 percent of the total value of natural resource property claimed, not including the operating allowance.

g. **<u>Any other tangible or intangible personal property</u>:** Used in the operation of the forestry business.

4. **<u>Tax Credit Computations:</u>** Fraction based on Percentage of Natural Resource Property in estate. *See* Table #3.

<u>Table #3</u>		
<u>Gross Estate:</u>		**$2,000,000**
<u>Estate Tax Payable to Oregon</u>		**$ 101,250**
<u>NRC Property Claimed as Credit</u>	**$1.1 Million**	
<u>Adjusted Gross Estate</u>	**$2.0 Million**	
<u>Ratio: NRC to Adj Gross Estate</u>	**55.0%**	
<u>Natural Resource Credit</u>		**$ 55,688**
<u>Net Oregon Estate Tax</u>		**$ 45,563**

5. **<u>Operating NRC Property and Avoiding Disposition Tax</u>**

a. **<u>Replacement of Real Property:</u>** Must be replaced with qualifying real property within one (1) year (or two (2) years in the case of involuntary conversions).

b. **<u>Replacement of Personal Property:</u>** Replace with any kind of NRC property.

c. **<u>Transfer to other family members</u>:** No disposition tax.

6. **<u>Disposition Tax</u>:** If NRC property is disposed of before five (5) years of forestland use is completed by the inheriting family members some or all of the credit has to be repaid.

a. The additional tax is due from heir who causes disposition.

b. The payment of Federal or Oregon Estate Taxes from NRC assets is a taxable disposition.

c. The tax and the tax return are due within six (6) months after date of disposition event.

i. Taxpayer can obtain an automatic 6-month extension to file the tax form and may apply for an extension of the time to pay.

d. The Disposition Tax is reduced by the number of months of actual NRC use. In order to avoid the Disposition Tax the taxpayer must use the property as a forestland business for 60 months out of 84 months following the decedent's death.

e. The taxpayer is also required to report dispositions which are non-taxable events such as a transfer to another family member or the replacement of NRC property with NRC property.

7. Annual Reporting Requirements

a. Annual Status Reports: Due April 15th of each calendar year after the Estate Tax return filed.

i. Annual reports required until five years of NRC use completed.

ii. Family Member using the NRC property must report status for each property that was subject to NRC election.

1) Indicate property still being used in forestry business.

2) Identify each asset that has been replaced with qualified NRC property.

3) Identify each asset that has been disposed of.

b. ODR will not grant any filing extensions for this annual report.

IV. Applying current Oregon law to formulate the succession plan

A. Identify the successor who will manage the forestry property.

B. Identify heirs who will not participate in the management of forestry property, and how to treat non-participating heirs fairly but not necessarily equally.

C. What is the current tax basis if property must be sold or is being considered for a gift?

D. Planning for basis increase after second spouse's death

1. Use Marital Deduction options at first spouse's death

a. Give NRC property to surviving spouse.

b. Give NRC property to Marital QTIP Trust

2. Consider whether or not to transfer NRC assets to a Credit Shelter Trust.

3. Oregon Estate Tax Savings may be less than Income Tax savings: Especially, when considering basis adjustment at the second death.

E. Lifetime Gifting – usually no gift tax, but also no basis adjustment.

1. Gift may cause taxpayer to fall below 50% or more of NRC assets requirement.

F. <u>Plan for Satisfying Obligations at Death or Illness</u>

1. **Consider Life Insurance to fund liquidity needs.**
2. **Extension to pay tax can apply for extension up to 14 years if reasonable cause exists. Oregon Rate (currently 4.0%) is higher than IRS rate.**

G. <u>Transfer Forestland to LLC and then change domicile</u> to state with no estate tax such as – California, Idaho, Nevada, or Arizona.

H. <u>Entities for holding forestry property</u>

1. **Sole ownership/sole proprietorship:** NRC eligible, no liability protection, limited succession planning options; no valuation discount for sole ownership, may be easier to meet 50% of estate NRC requirement. Unless NRC property is in trust a probate to transfer the property may be required.
2. **Joint ownership, right of survivorship, tenancy by entirety:** NRC eligible, non-probate transfer to survivor(s), no liability protection, limited succession planning options, valuation discounting because of multiple owners. Survivors must be family members.
3. **Limited Liability Company:** Assets in LLC are NRC eligible, limited liability protection, multiple transfer options for LLC interests; can adjust economic and management rights; can be taxed as sole proprietorship, partnership or corporation. LLC interests must be owned by family members and at least one family member must materially participate in the business.
4. **Trust:** Assets in Trust are NRC eligible, limited liability protection for beneficiary and trustee; generally higher income taxes than individuals would pay. Beneficiary must be family member. Probably trustee needs to be family member and participate in the family business.
5. **General Partnership:** Assets in partnership are NRC eligible, joint and several liability, can be dissolved by any partner; not an effective succession device but can be helpful in reducing discounts.
6. **Limited Partnership:** Assets in partnership are NRC eligible, joint and several liability for general partner, limited liability for limited partners, not used much since limited liability companies became available.
7. **Corporation (C or S):** Assets in corporation are NRC eligible, generally should not own real estate, liability protection for shareholders; can create voting and non-voting interests, no basis adjustment for assets held in the corporation, can transfer to next generation during lifetime or at death. Shareholders must be family members and at least one family member must participate in the family business.

I. Oregon Estate Plan for Married Couple:

1. **Disclaimer Trust Estate Plan for Surviving Spouse.** Under this type of estate plan, all of the assets of the first spouse to die are distributable outright to the surviving spouse or to a QTIP trust for the surviving spouse. The surviving spouse is given a choice through the use of a disclaimer to transfer all or part of the assets from the estate of the first spouse to die to a disclaimer trust structured as Credit Shelter Trust ("CST") for the benefit of the surviving spouse. By disclaiming the surviving spouse can elect to transfer up to $1,000,000 and fully utilize the deceased spouse's Oregon exemption. The CST could be for the sole benefit of the surviving spouse or for the spouse and descendants.

Table #4		
Disclaimer Estate Plan (Will or Trust) of First Spouse to Die		
All Assets to Surviving Spouse or QTIP Trust		
	Disclaim > >	**Bypass or Credit Shelter Trust (CST)**
Funded with descendant's assets over $5.430 million.		Funded Up to $1 million
(Subject to Federal Estate tax and Oregon Estate Tax when surviving spouse dies)		(Exempt from Oregon Estate Tax and Fed. Estate Tax at 1st spouse's death and at 2nd spouse's death)
Basis adjustment when 2nd Spouse dies		No basis adjustment when 2nd Spouse dies

Table #5	
ADVANTAGES	**DISADVANTAGES**
Step-up at second death for assets not disclaimed	No step-up in basis at the second death for the assets in the CST
All growth in CST is exempt from estate tax	Additional State & Federal Estate Tax exposure for assets not disclaimed
Spouse controls property until it is disclaimed	Surviving spouse may elect not to disclaim any property. Easy for surviving spouse to override plans of deceased spouse, especially complex

	family structures
Residence and Annuities tax benefits can be maintained if not disclaimed	No Asset & Bloodline protection for assets not disclaimed
GST Exemption can be allocated to CST	GST Exemption not portable
	Wastes Oregon's $1 million exemption if disclaimer is not fully utilized
	Possible annual Income taxation with the CST if funded

2. Formula Plan

Table #6		
Estate Plan (Will or Trust) of First Spouse to Die		
Surviving Spouse or QTIP Trust	**Oregon QTIP or OSMP Trust**	**Bypass or Credit Shelter Trust**
Funded with descendant's assets over $5.430 million.	Funded up to $4.430 million, (the GAP Trust)	Funded Up to $1 million
(Subject to Federal Estate tax and Oregon Estate Tax when 2nd spouse dies)	(Exempt from Federal Estate Tax, but subject to Oregon Estate Tax when 2nd spouse dies)	(Exempt from Oregon Estate Tax and Fed. Estate Tax at 1st spouse's death and at 2nd spouse's death)
Basis adjustment when 2nd Spouse dies	No basis adjustment when 2nd Spouse dies	No basis adjustment when 2nd Spouse dies

V. **Questions**: If you have any questions, please contact me at:

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