



Just the Facts—Basic Elements of Federal and Oregon Transfer Taxes

.5 Oregon Practice and Procedure credit

From the Oregon State Bar CLE seminar *Basic Estate Planning for Oregon Taxable Estates*, presented on November 15, 2019

Chapter 1

Presentation Slides: Planning for the Oregon Estate Tax—The Basics

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Planning for the Oregon Estate Tax – The Basics

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Introduction

- Objective for most clients is to maximize the inheritance of their heirs
- Why today's focus on the Oregon estate tax?
- 2 reasons:
 - Current high real estate and stock portfolio values means more people will probably become subject to the OET
 - Very high federal exemption means most clients no longer need to worry about the federal estate tax
- Maximizing inheritance used to mean minimizing the estate tax, but is this still the case?

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Case Study

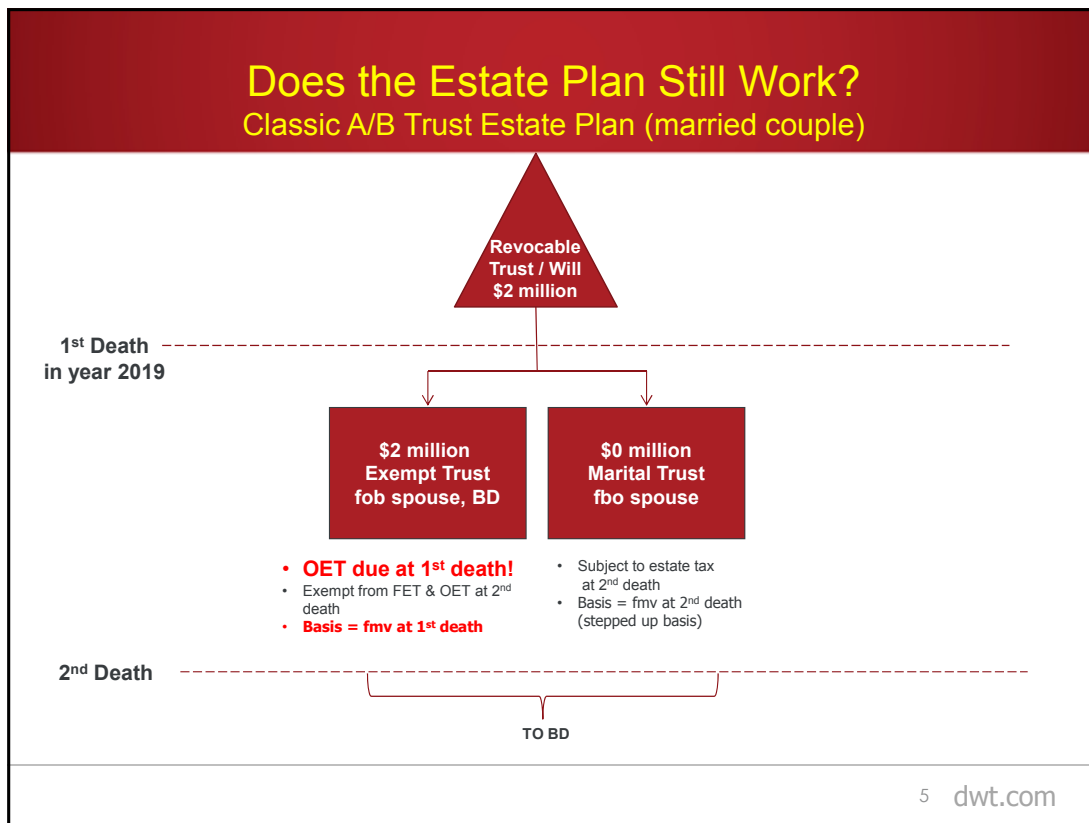
- Married couple, Ms. Beaver and Ms. Duck
- Have one child, BD.
- Combined estate of \$4 million, or \$2 million each
- Objective is to maximize BD's inheritance
- Wills from 1999
 - Credit shelter trust (also called the exemption trust, bypass trust, family trust) to be funded with max amount, excess to a marital trust

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How does their old estate plan work?

- Wills from 1999
 - Credit shelter trust (also called the exemption trust, bypass trust, family trust) to be funded with max amount necessary to result in the least possible federal estate tax
 - Distributions of income and principal can be made to spouse and BD for HEMS
 - After credit shelter trust is funded, any excess will fund a marital trust for surviving spouse
 - At death of second spouse, all remaining assets go to BD

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Does the Estate Plan Work?

Not really:

- First, unless an Oregon Special Marital Property election is made, there will be an OET of \$101,250 due on the first death.
 - Why? Because the Credit Shelter Trust is funded with \$2 million, which exceeds the \$1 million Oregon exemption amount. No marital deduction is available unless OSMP election can be made
 - More details in Amelia Heath's and Eric Weiland's presentations

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Does the Estate Plan Work?

Second, the basis of the assets in the Credit Shelter Trust will be frozen as of the 1st death.

This means that although there will not be any estate tax on the 2nd death, when BD sells the assets, BD will pay state and federal income tax on any gain.

Oregon estate tax rates are 10%-16%, while the top marginal combined federal and state income tax is 31%.

If the objective is to maximize the inheritance going to BD, this plan probably does not meet the objective

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How Did We Get Here? Some Historical Background

The Oregon estate tax was instituted in the early 1900s.

The federal estate tax was instituted in 1916; states also had estate and inheritance taxes.

Then, as now, some states competed in a race to the bottom on estate taxes.

Starting in the late 1920s, because of a 1926 federal law which allowed for sharing the federal estate tax with states via a credit, every state had an estate tax (NV held out until 1987). This changed in 2001, with the Bush tax cuts (Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)), which ended the sharing system.

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Background (cont'd)

Now, most US states do not have any estate or inheritance tax.

Oregon is one of about 18 states that still have an estate or inheritance tax.

WA & OR are the only western states with an estate tax (plus HI if it counts as a western state).

Of relevance to Oregon residents and their estate planners: CA and AZ do not have an estate tax. WA has the highest estate tax rate in the US, but, compared to OR, a higher threshold of \$2.193 million (indexed).

Note: despite the higher threshold, the higher rate means that wealthy clients will pay more estate tax in WA than in OR.

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Transfer Taxes

■ Federal Scheme:

- Imposed on lifetime gifts and transfers at death
- Extra tax on generation skipping transfer (GST tax, 40%)
- 40% maximum rate for gift and estate taxes
- 2019 applicable exclusion amount of \$11.4 million (indexed) for lifetime and death transfers
 - This means you can give away at death and/or during life, a total of \$11.4 million without paying a federal transfer tax
 - This amount is indexed, meaning it increases to reflect inflation.
 - 2017 Tax Cuts and Jobs Act (TCJA)
 - The expanded exemption amount under TCJA will expire on 12.31.2025, unless Congress extends

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Transfer Taxes

- Federal Scheme:
 - Annual exclusion gifts (annual gifts free of gift tax)
 - you can also make annual exclusion gifts (currently up to \$15,000/person) without eating into the applicable exclusion amount
 - Portability between spouses (but, GST exemption is not portable)
 - a surviving spouse can use deceased spouse's unused applicable exclusion amount, no need to preserve it with a trust
- OR Scheme:
 - Imposed on transfers at death only. NO gift tax or GST tax
 - Progressive rate, from 10% - 16% (\$9.5 million plus)
 - Exclusion amount is \$1 million (not indexed)
 - No portability between spouses
 - The only way to preserve the \$1 million exemption is to use a trust at the first death

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Transfer Taxes

Of relevance to Oregon residents and their estate planners:

- CA and AZ do not have an estate tax.
- WA has the highest estate tax rates in the US, 10-20%, but a higher threshold of \$2,193,000 (2019, indexed)

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OET Rate Schedule (ORS 118.010(4))

Column 1 Taxable estate equal to or more than:	Column 2 Taxable estate less than:	Column 3 Tax on amount in column 1:	Column 4 Tax rate on taxable estate amount more than the amount in column 1 (percent):
\$ 1,000,000	\$ 1,500,000	\$ 0	10.0%
1,500,000	2,500,000	50,000	10.25%
2,500,000	3,500,000	152,500	10.5%
3,500,000	4,500,000	257,500	11.0%
4,500,000	5,500,000	367,500	11.5%
5,500,000	6,500,000	482,500	12.0%
6,500,000	7,500,000	602,500	13.0%
7,500,000	8,500,000	732,500	14.0%
8,500,000	9,500,000	872,500	15.0%
9,500,000		1,022,500	16.0%

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Transfer Taxes – income tax concerns

- If the estate planning objective is to maximize BD's inheritance, then for the Oregon taxable estate, the estate planner has to plan for the income tax and the estate tax.
- Oregon estate tax rates: 10% - 16%, with 16% hitting at \$9.5 million.
- Combined Oregon and federal capital gains plus surcharge tax rate: 24% - 32.8%
- Because the income tax rate is > Oregon estate tax rate, estate planners have to re-think traditional estate planning techniques such as gifting, splitting up assets in order to reduce value through minority discounts, because getting a maximum basis step-up at death in order to reduce income taxes might be a better deal than reducing the estate tax.

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Transfer Taxes – income tax concerns

Ms. Duck is an elderly widow with \$2 million of assets. She wants to leave as much as she can to her child BD and she does not want to pay estate taxes.

- She gives BD shares of Apple stock worth \$1 million, with a basis of \$100,000. BD wants to diversify his portfolio and decides to sell the Apple stock. He pays income tax on \$900,000 of gain.
- The Beavers win the Civil War game, and a shocked Ms. Duck dies of heart failure before she can give the Apple stock to BD. The estate tax bill is \$101,250. BD receives his inheritance, including the \$1 million of Apple stock. BD sells the Apple stock, which now has a basis of \$1 million and pays no income tax.
- But what if Ms. Duck gives BD \$1 million of stock with \$1 million of basis?
- Stay tuned for more information on this topic from Robin Smith, who will cover gifting and income tax traps.

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What is the Oregon Taxable Estate?

Must reads:

ORS Chapter 118 (“Estate Tax”)

OAR Chapter 150, division 118 (“Inheritance Tax”)

Internal Revenue Code (Title 26, Subtitle B, Estate and Gift Taxes)

Oregon Estate Return (Form OR-706)

Federal Estate Tax Return (Form 706)

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What is the Oregon Taxable Estate?

Oregon taxable estate:

- Worldwide assets (federal taxable estate, IRC 2031(a), ORS 118.005(6))
- Plus:
 - any deduction for transfer taxes allowed under IRC 2058 (state estate tax deduction)
 - If decedent is surviving spouse, OSMP property or OR QTIP property
- Less:
 - OSMP property, QTIP property and any other applicable deductions.

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Who Pays the Oregon Estate Tax?

Oregon residents

Nonresidents with Oregon real property or tangible personal property located in Oregon*

*Many non-Oregon practitioners believe that if the Oregon real property/tangible personal property has value of under \$1 million, no OR estate tax is payable or OR estate return filing is required

But, if the nonresident's gross estate exceeds the filing threshold amount of \$1 million, an OR estate tax return must be filed

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Calculating the Oregon Estate Tax: Non-residents

For non-residents with OR real property or tangible personal property, the OR estate tax is based on the value of the OR property as compared to the overall estate.

1st: calculate OET as if nonresident is an OR resident

2nd: multiply OET by ratio of OR property to gross estate:

$$\text{OET} \quad \times \quad \frac{\text{Oregon real property/TPP}}{\text{Gross estate}}$$

For more details, see Phil Jones' materials.

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Calculating the Oregon Estate Tax: Residents

For residents with real or tangible personal property outside of OR, the OR estate tax is reduced based on the value of the OR property, which includes intangible property, as compared to the overall estate.

1st: calculate OET on worldwide assets

2nd: multiply OET by ratio of OR property to gross estate:

$$\text{OET} \quad \times \quad \frac{\text{Oregon real, intangible and tangible property}}{\text{Gross estate}}$$

For more details, see Phil Jones' materials.

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What Reduces the Oregon Estate Tax?

- Real and tangible personal property located outside of Oregon
- Oregon Natural Resource Credit
 - Farming, fishing forestry businesses
 - Similar to IRC 2032A
 - Still gets basis step-up
 - Need to balance restrictions on business with need for credit
- Deathbed gifts
 - Oregon has no gift tax, so deathbed gifts can reduce the estate without reducing the \$1 million Oregon exemption. However, gifts have carry-over basis.

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Planning for Married Couples

For married couples, the marital deduction is huge, because it delays the estate tax to the second death.

Rationale: gives married couples an incentive to provide for surviving spouses so the state doesn't have to support them.

Gifts to surviving spouses are not subject to tax, and are deducted from the taxable estate as marital deductions. Certain trusts for surviving spouses will qualify as marital deduction gifts.

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Planning for Married Couples

- IRC 2056 – Bequests, etc., to surviving spouse
- (a) Allowance of marital deduction

For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsection (b), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse...

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Planning for Married Couples

IRC 2056(b)(7): added in 1981, allows for marital deduction for a trust FBO surviving spouse

Oregon QTIP: property that qualifies for the federal marital deduction (IRC 2056(b)(7)):

- Spouse is the only beneficiary; and
- all income to surviving spouse.

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QTIP vs OSMP

The Oregon Problem:

Old estate plans often mandate creation of a trust at 1st death equal to the federal exclusion amount, the “credit shelter trust”.

The \$11.4 million exclusion amount results in large credit shelter trusts, perhaps comprising the entire estate.

A credit shelter trust will not qualify for an Oregon QTIP election if there are beneficiaries other than the surviving spouse, or if all income is not required to be paid to the surviving spouse.

This results in an Oregon estate tax at the first death.

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QTIP vs OSMP

The Oregon Solution:

Oregon Special Marital Property election is designed to save clients from outdated estate plans. (ORS 118.013)

- A trust that does not require distribution of all income and that has current beneficiaries other than the surviving spouse can qualify for the OSMP election.
- Won't save every surviving spouse from the OET at the first death, but it can be very helpful.
- For details, see Amelia Heath's and Eric Weiland's materials.

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QTIP vs OSMP

But, there might still be a problem.

The OSMP elections can avoid the OET upon the first death.

But, where there is little chance of a federal estate tax liability on the second death, getting a federal basis step-up is more important than saving on Oregon estate taxes.

If the old estate plan's credit shelter trust does not qualify for the federal marital deduction, then there will not be a basis step-up at the second death for federal income tax purposes.

When drafting plans, add flexibility so that qualifying for the federal marital deduction is an option.

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Oregon Estate Tax: Filing and Payment

- Form OR-706 and payment is due within 9 months of the date of death (Form IT-1 for deaths prior to 1/1/2012)
- Form OR-706 uses IRS Form 706 schedules
- Use IRS Form 4768 to file for a 6 month extension of time to file
 - Must be filed on or before 9 month deadline
- If have approval of extension of time to pay by filing date, then file copy of approval with OR-706

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Filing and Payment

- Use IRS Form 4768 to file for an extension of time to pay
 - See OAR 150-118-0150
 - Must be filed on or before 9 month deadline, with a written explanation of why the tax cannot be paid
 - Will be granted for up to 14 years if “reasonable cause exists and acceptable collateral is provided”
- OAR 150-118-0150(4): examples of “reasonable cause”
 - Can raise cash only by selling assets at a loss
 - Closely held business interest comprises > 35% of gross estate or 50% of net taxable estate

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Filing and Payment

Examples of collateral generally accepted by DOR (OAR 150-118-0150(4)), all with value twice the amount of tax owed:

- Mortgage on real or personal property
- Bond issued by a surety company

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Filing and Payment

Extensions of Time to Pay:

- Interest rates:
 - Oregon: 6% starting 1.1.2019, (Oregon Revenue Bulletin 2018-02) (ORS 305.220, OAR 150-305-0140)
 - IRS: federal short term rate plus 3%.

Note that the IRS does not always require collateral, and may offer a lower interest rate.

Interest is deductible under 2053.

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Will the OET Disappear?

Probably not.

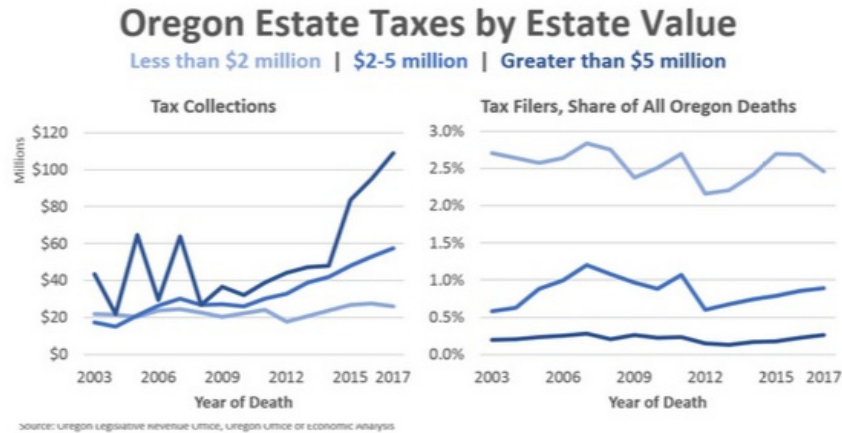
In 2017, 3.6% of Oregon decedents were subject to the Oregon estate tax. By comparison, it was estimated that about 0.06% of US decedents would be subject to the federal estate in 2018.

In 2019-2021, revenue from the OR estate tax is projected to be \$342 million, compared to \$354 in 2017-2019. 1/5 of 7% of Oregon general funds comes from the OR estate tax.

Source: Oregon Dept of Revenue Research Section. State of Oregon Tax Expenditure Report: 2019-2021 Biennium. Salem, OR: Oregon Dept of Administrative Services, 2018;

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Oregon Estate Tax Statistics



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Case Study

Back to married couple, Ms. Beaver & Ms. Duck and their child, BD.

- Maximize BD's inheritance by:
 - Eliminating the OET at the first death
 - Considering income tax consequences of traditional estate value reduction techniques such as deathbed gifting, valuation discounts
- Utilize a flexible estate plan that anticipates changes to the federal and state exemption amounts

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