

TAXING QUESTIONS

by

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VFA provides this opportunity for questions about income, and estate and gift tax issues that affect your Tree Farm. Treat the answers as educational advice for improving your understanding of the tax law and for enhancing communication with your attorney or tax advisor. Your advisors are familiar with the facts and circumstances in your specific case and can provide legal and tax advice as appropriate. All questions are edited to protect your privacy.

Question One: Dear Dr. Haney, Over the years I have bought a lot of timber for cutting in my sawmill. Many times land was included as part of the deal, but I kept it separate from the sawmill operation. Managing the sawmill took most of my time and consequently left little energy for managing residuals left after cutting. Recently, I hired a forester to buy timber for the mill. After looking at some of this ignored land he advised that it now supports valuable timber in spite of my lack of attention. In addition, several properties are located in neighborhoods with potential residential development and some apparently have exceptional recreational value. At home, my wife of many years and I get along well, and we are concerned about the well being of a son with severe disabilities as well as three healthy adult children and their families. My wife looks after our son with disabilities, and I tend to the business, but I worry about what the future holds for the family. My health isn't as good as it once was. What will happen to the timberland if my health fails?

Sincerely, Worried Sawmill and Landowner

Answer One: Dear Worried, Indeed, it seems that success from your hard work is yet to be fully realized. Enjoying the benefits of abundant family resources includes the peace of mind that you have provided not only for the family's current needs, but also for future needs through an orderly estate succession plan. This is one of the legal concerns addressed by John Burke elsewhere in this magazine. Key questions to be addressed include business continuity, managerial control and minimization of transfer taxes. Assuming that continuity of the timber business and estate and gift tax saving are primary goals, there are several choices for passing estate assets to your heirs. Who will control the business depends on your goals and the children's interest in participating in the business. That is, will they be actively or passively involved in the business? Of course, there must be a plan to care for your disabled son. The general estate planning steps are discussed briefly with more emphasis focused on business organizations for continuity of management. Due to the expected size of your estate, completing the plan will require a qualified estate planning team. In the meantime resolution of family goals and issues of control require effective communication within the family. Such efforts to reach consensus on goals and healing of any family rifts may be one of the most fruitful and least expensive steps in the plan.

The Problem. With failing health your estate may face unexpected values in the appraisal of the forest land resulting in heavy tax levies. The fair market value of appreciated forest land often greatly exceeds the value attributable to such property from current cash flows. That is, fair market values often exceed the use value of the timber assets. The Internal Revenue Service (IRS) focuses its estimates of value on the "highest and best use" of the property, preferring market transactions evidence of value over other methods wherever possible. Consequently, the IRS valuations are often much higher than the value placed timberland assets in their current use by your executor.

This year (2008) each person (as a decedent) has an exemption equivalent of \$2 million which corresponds to an applicable credit of \$780,800. That is, for every dollar of taxable value over \$2 million the marginal tax rate is 45 percent. In 2009 the exemption equivalent increases to \$3.5 million with an applicable credit of \$1,455,800. In 2010, the estate tax is repealed, but for only one year unless Congress acts. If Congress fails to act, the estate tax statutes reverts to the provisions applicable under the 2001 Tax Act creating great uncertainty for you and other forest landowners.

Doing Nothing. In spite of the uncertainty, you cannot afford wait for resolution. The opportunity to decide what will become of your estate is a privilege accorded to each person in the United States. You are not required to write a will or otherwise plan for the disposition of your assets at death. The state where you live has a plan for your assets in the event that you fail to act called the law of “descent and distribution”. Your surviving spouse, children, parents, brothers and sisters and other relatives are considered in more or less that order. State law varies in this regard, however, and becomes more complicated when multiple marriages are involved which may result in unexpected heirs. If you die intestate (i.e., without a will), the state will appoint an administrator to manage the disposition of estate assets. This person may not be someone you would choose. He (she) will enumerate your gross estate value, pay debts and taxes including your Federal estate tax, and file the estate tax return. The remainder will be distributed to your spouse and the children according to state statutes without regard to needs or contributions by family members to the estate’s value. Under these circumstances the administrator has limited options for reducing the amount of estate taxes or addressing family goals. Thus, for a person in your situation, a plan is essential for achieving family goals and preserving estate values by reducing death taxes.

A Basic Plan. Even a simple plan can meet some family needs, save taxes, and improve on the state's plan. The so-called "I love you will," will defer estate taxes at your death because the values left to a surviving spouse are protected from estate tax by the marital deduction. Of course, this simple strategy overlooks two fundamental problems. Leaving everything to your spouse defers the estate tax, but it wastes the applicable credit of \$780,800 in 2008, or \$1,455,800 in 2009. Although this approach allows additional time to plan, simply deferring estate tax increases estate tax problems for the surviving spouse because estate taxes are not avoided, but simply deferred.

A Formula Will. An improved will uses a formula to transfer estate value equal to the exemption equivalent to your children, thus utilizing applicable credit. There are various formulas that direct an amount equal to the exemption equivalent to the heirs, either outright or in trust. In 2008 an amount equal to \$2 million is bequeathed to the children, which saves an amount equal to the applicable credit of \$780,800. The balance is directed to the surviving spouse where it is shielded with the marital deduction, and all estate taxes are deferred at the first death. This plan is illustrated in the attached Figure. Of course, the exemption equivalent increases in 2009.

In the simplest case, the timberland property is simply bequeathed outright to the children as the heirs. The children should be of age and maturity to be able to manage these assets, and second, the surviving spouse must be satisfied to forego income from these assets which she (he) have presumably helped earn as a spouse. If the survivor, needs income from the amounts bequeathed to the children, the will can establish a credit bypass trust and a marital trust.

Trusts. Trusts are remarkable instruments that can bridge life and death. They can be designed to do things that you as the decedent cannot do for yourself. For example, a trust can be created and funded to provide for your handicapped child after you and your spouse's death. Similarly, a trust can be

designed to manage the timberland for the mature children who may have other jobs and interests elsewhere. A marital or family trust can be utilized to hold and manage timberland bequeathed to the surviving spouse. In blended marriages where children are the intended beneficiaries, but the survivor needs the income and the estate needs the marital deduction, a qualified terminal interest trust or QTIP can be used. It qualifies for the marital deduction because the survivor gets the income from the trust, distributed at least annually, but the residue goes to the children as heirs at the second death.

While trusts are valuable planning tools, the downside is that trusts are expensive, and the decedent (grantor) must give up control of estate assets to the trustee. Qualified legal and accounting advice is essential when trusts will be part of the transition plan.

Special Forestry Provisions. In addition to the general estate planning provisions sketched above there are two alternatives that apply to active businesses including forest ownerships. First, **special use valuation** (IRC Section 2032A) permits timberland to be valued in its forestry use rather than at the IRS' preferred "highest and best use". Market value can be reduced to use value up to a maximum of \$970,000 (in 2008) potentially reducing estate taxes by \$436,400. While not needed to defer taxes at the first death, it permits up to \$2,970,000 in market value to be transferred directly to the heirs or into a by-pass trust which passes tax free to the children at the survivor's death. Similarly, a special use election reduces the taxable estate value at the survivor's death by a like amount. Note that these amounts are indexed and change with the statutes. The potential savings are substantial; however, the requirements for qualification are stringent. For details, see previous issues where special use was discussed in this column.

Deferral and Extension of tax payments (IRC Section 6166) allows qualifying forestry businesses to defer estate tax payments for four years paying only the interest, and then paying the tax

and interest in two up to ten annual payments. This provision allows the executor to get the estate's affairs in order before paying the tax. It is especially useful in forestry circumstances where premature harvesting in young timber stands would forego considerable potential income. The interest is favorably set at two percent on taxes on the first \$1,000,000 in taxes owed, and 45 percent of the applicable rate on the excess of taxes on amounts over \$1,000,000. To qualify the timberland must be operated as an active business and meet certain other parameters.

The organizational control of your timberland can be managed in a variety of ways including fee simple title, joint ownerships, partnerships, corporations and trusts. Two additional methods offer considerable advantages in terms of operational control, facilitation of gift transfers to the children, liability protection for participants, and both income and estate tax advantages. Family Limited Partnerships (FLPs) and Limited Liability Companies (LLCs) are discussed briefly below.

Family limited partnerships (FLPs) must be formed in compliance with State law. Limited partners have no personal liability beyond their investment in the partnership, but they may not participate in the management. This permits the exclusion of certain family members from control, for example minors, distant owners, or perhaps a parent who wishes to withdraw from management.

For planning purposes, a family limited partnership is created by transferring assets likely to appreciate rapidly (e.g., young plantations) to a newly created limited partnership. In exchange, the transferor (parent) generally receives a small general partnership interest (typically 1 to 2 percent) and a large limited partnership interest. The transferor retains the general partnership interest and over a period of time gifts limited partnership interests to family members – usually children – using the gift tax exemption (\$12,000 in 2008). These interests are usually minority interests. The general partnership

interest gives the transferor operational control of the business even though that interest represents only a small percentage of its value.

Limited partnership interests transferred to children under an FLP are worth significantly less for gift tax purposes than a proportionate interest in the underlying assets. As noted, limited partners cannot decide how the business is run, demand distributions, or force a liquidation. Thus, FLP interests may be less marketable than an interest in the underlying business assets – the land. The combination of minority interest and lack of marketability gives rise to discounts on such interests in the 20 to 40 percent range or higher. In addition, a FLP gives the ability to retain control of gifted assets, ease of probate, protection from creditors, and facilitation of the gift tax annual exclusion. FLPs are pass-through entities for Federal income tax purposes.

But, in 1997, the IRS attacked discounts in FLPs under two doctrines. First, the IRS argued that death-bed transfers were sham transactions which served no valid business purpose. That is, they were similar to a single testamentary transaction in which no discount was warranted. Alternatively, the IRS published several Technical Advice Memoranda denying FLP valuation discounts that were deemed to relate to “applicable restrictions.” With respect to a FLP, an applicable restriction effectively limits the ability of the partnership to liquidate and the transferor or any member of the transferor’s family has the right after the transfer to remove the restriction. Limitations on the ability to liquidate the partnership more restrictive than the limitations that would apply under State law are deemed an applicable restriction. A full discussion of this issue is beyond the scope of this reply; however, the IRS argues that any option, agreement, or restriction on the right to dispose of the property without a bona fide business purpose does not give rise to a discount.

The strategy to circumvent the IRS restrictions involves a clear business purpose with a profit motive, a diffusion of control, and a sharing of benefits within the family from the enterprise. A long history of profitable management and good records are valuable in making the case for the discounts. Consequently, a decision to use a FLP should be executed with expert legal and accounting help.

A **limited liability company (LLC)** is a hybrid entity that combines the corporate benefit of limited liability for its owners with the partnership's advantage of pass-through treatment for income tax purposes. It is created under State law, just like a corporation. Instead of filing articles of incorporation, LLCs file articles of organization with the designated State authority.

An LLC is owned by its members, rather than by shareholders or partners as with a corporation or partnership. Members of an LLC may include a corporation, partnership, trust, estate, another LLC, or other legal entity, as well as an individual. Contributions to an LLC in exchange for a membership interest may be made in the form of cash, property, the use of property, services, or any other valuable consideration.

Generally, an LLC is not required to have an operating agreement (OA), but some States require one and specify certain mandatory provisions. Provisions concerning an LLC's affairs may be included in an OA to the extent that they are not inconsistent with State law or the articles of organization. Typical LLC statutes make extensive use of default rules, which are statutory provisions that apply unless the articles of organization or OA specify otherwise. Default rules allow an LLC to go beyond the statute to customize administration and management to suit the needs of its members. The statute generally reserves management rights for members in proportion to their capital contributions, unless the articles provide differently. Members of an LLC are usually permitted to customize both distribution of cash and property, and allocation of profits and losses, to themselves through the OA or articles. In the absence of

such special financial provisions distributions, profits and losses are allocated proportionally in accordance with the members' respective contributions.

Members of an LLC are generally permitted, unless otherwise provided in the articles or OA, to withdraw on 6-months notice and receive the fair market value of their interests. Withdrawals, deaths, bankruptcies, and other events that cause the loss of a member can have serious consequences because the LLC could terminate unless the remaining members agree to continue the business.

Unless the OA or articles provide otherwise, a membership interest is assignable. The assignment entitles the assignee to receive the distributions to which the assignor would otherwise have been entitled. In order for an assignee to participate in an LLC's management the remaining members must unanimously agree to the assignee's admission as a member.

Limited Liability. A key advantage of an LLC is the provision for limited liability to all of its members. This is the primary distinction between an LLC and a limited partnership. In the latter, general (managing) partners usually have unlimited liability with respect to partnership debts. On the other hand, the typical State LLC statute provides that an individual or entity belonging to an LLC does not have any personal obligation for the LLC's obligations solely because of being a member.

A second primary reason for using an LLC is tax related. An LLC avoids the double taxation associated with a corporation with pass-through taxation for members. Thus, from an income tax perspective, an LLC compares favorably with both S corporations and partnerships but at the same time has additional advantages not available with the other two types of entities. For example, an LLC member can materially participate in the LLC's business activities, so that income and losses that are passed through to him (her) are considered active under the passive loss rules, without risking personal

liability. An LLC member's basis includes a share of all LLC liabilities. Neither an LLC nor a member recognizes any gain or loss if the LLC distributes appreciated property to the member.

An LLC classed as a partnership with limited liability in all jurisdictions in which it will operate combines ownership, operational, tax, and liability advantages in a way that neither the Subchapter S corporation nor the FLP can do. LLC shows great promise as an advantageous way to organize family-owner tree farms for current operations.

The LLC has potential as an estate planning tool, but since the LLC format is relatively new, its use in estate planning involves some uncertainties. Use of the gift tax exemption and valuation discounts discussed above may be attacked by the IRS as they have for FLPs. For example, in *Hackl, C.M. v. Commissioner* (118 T.C. 279, affirmed 335 F.3d 664 (CA-7), 2003-2 USTC ¶60,465), the transfer of LLC timberland interests to the donor's children was held to be gifts of future interests that failed to qualify for the annual gift tax exclusion. Hackl retained the personal right to name a successor; to permit or deny withdrawal of capital contributions by a member; make or withhold cash flow distributions; and permit or deny the transfer or encumbrance of membership interests. Furthermore, the LLC had failed to make distributions to members for several years and adopt a forest management plan to seek long-term appreciation and income.

Several planning options exist that should circumvent the *Hackl* result. These include granting recipients of LLC interests withdrawal rights, permitting sales of LLC interests subject to rights of first refusal, granting donees for a limited time a right to sell interests to anyone, making gifts of cash which are then used by the donees to purchase the interests, and providing for mandatory distributions at prescribed earnings levels.

In summary, it is important to decide how managerial control will be shared in the business for the future. Several estate planning steps were sketched that preserve estate values for the use of the family. They require carefully planning in order for the estate to capture these saving. The transfer of the business to the children using the gift tax exclusion takes time, and with the state your health, should be begun immediately. The estate and gift tax laws, regulations and court precedents are complicated so qualified advisors are essential for successful planning. Take heart, anyone who can operate a sawmill profitably and rear four children can make a satisfactory estate plan.

UPCOMING PROGRAMS:

A two-day program on **Estate Planning for Forest Landowners** sponsored by the Extension Service, Department of Forestry and Natural Resources, Clemson University, will be offered in Columbia, SC, on February 17-18, 2009. For information on timber taxes contact VFA or email to <hhaney@vt.edu>.

Source: Virginia Forests, Winter 2008