

Lane Shetterly
Chair

Jeffrey C. Dobbins
Executive Director



Wendy Johnson
Deputy Director and
General Counsel

Lisa L. Ehlers
Legal Assistant

OREGON LAW COMMISSION

MEMORANDUM

DATE: March 16, 2011
TO: Senate Committee on Finance and Revenue
FROM: Lane Shetterly, Oregon Law Commission Chair and Inheritance Tax Work Group Chair
Wendy Johnson, Oregon Law Commission Deputy Director and General Counsel
RE: Inheritance Tax Law Reform Project Interim Update (SB 326)

MEASURE: SB 326
EXHIBIT: A
Senate Finance and Revenue 76th Session

DATE: 03-16-2011 PAGES: 7
SUBMITTED BY: Lane Shetterly
Wendy Johnson

INTRODUCTION:

After the 2009 legislative session, the Legislative Revenue Office and several legislators, including the chairs and members of the House and Senate Revenue Committees, requested that the Oregon Law Commission conduct a law reform project regarding Oregon's inheritance taxation laws. The request was to review ORS Chapter 118 (the inheritance tax chapter) and make recommendations for any reform to the 2011 Legislative Assembly, including a proposed bill. Legislative leadership also requested periodic interim reports.

The Commission approved the law reform project in September 2009 and appointed a Work Group. The Work Group is chaired by Commissioner Lane Shetterly and is composed of nine members and eight advisors. The Work Group membership includes six lawyers with expertise in estate planning, elder law, taxation, and business entity law; a CPA; a tax academic; and the Hon. Henry Breithaupt, Oregon's Tax Court judge. Advisors include representatives from the Department of Revenue and Department of Justice; individuals with farm, nursery, and tax policy expertise; and representatives of the Governor's and House Speaker's offices. The Work Group also has the assistance of LRO and LC. The Work Group has met monthly since October 2009. Special subgroups were also formed and have met to focus on complex issues regarding natural resource property, marital property, and intangible property.

HOW DID OREGON GET HERE?

Oregon has had an inheritance tax since 1903. Since 1977, Oregon has tied its state inheritance tax to the federal estate tax system. That is, Oregon has relied largely on the federal estate tax code for its definitions and for determining the taxable estate. From 1926 to 2004, federal law permitted a credit on federal estate tax returns for state estate taxes paid. Thus, state estate taxes had very little burden on tax payers because the credit effectively made it a pass-through to states of money that otherwise would have gone to the federal government, anyway.

In 2001, the pass-through credit changed. In that year, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which phased out the state tax credit from 2001-2004. And in 2005, the credit on the federal return was completely eliminated and replaced with a deduction for state estate taxes paid. This new deduction on the federal return computes out to giving taxpayers approximately 45% to 50% back of what is paid in state estate taxes. In

addition, EGTRRA raised significantly the filing threshold for paying federal estate taxes; the threshold increase was phased in, moving from \$1 million in 2002 to \$3.5 million in 2009.

Most states, including Oregon, had set their state estate tax rate in statute as the maximum allowable credit on the federal return. When the credit was repealed, states that wanted to continue to receive estate tax revenues (including Oregon) had to decouple from the federal credit provision since it had been repealed. Twenty-eight states have amended their laws to repeal the estate tax or chose to let their estate tax expire when the pick-up tax expired. Almost all of the other states opted to amend their statutes and stay linked in some way to the pre-2001 federal code.

In 2003, Oregon opted to stay continually linked to the federal estate tax code as it existed on December 31, 2000 (2000 federal estate tax code). However, this structure is perceived as having both administrative and tax policy problems. Administratively, it is cumbersome because the 2000 federal estate tax code is getting more and more remote as time goes by, and more difficult for practitioners even to find. Tax policy issues tend to center around the different exemption amounts, treatment of surviving spouses, treatment of family businesses (particularly family businesses that are related to natural resources), and comparisons with other states. Oregon did diverge from the federal code and adopt a modified state QTIP provision known as Oregon State Marital Property in 2005 and a Natural Resource Credit in 2007. Those provisions have continued to carry some questions and concerns, partially because they are different from federal law and partially because they are complex, new, and present overlapping questions. On December 15, 2010, H.R. 4853 was enacted by Congress. Title III of that law reinstated the federal estate tax that had expired in 2010, increased the federal exclusion to \$5 million, and made further amendments to the law. All of these factors suggested the need for a comprehensive review of Oregon's own inheritance tax law and policy and a rewrite of ORS Chapter 108.

KEY FACTS:

- Oregon inheritance tax revenues currently average about \$200 million a biennium. Inheritance tax revenues are fairly volatile as revenue depends on who dies in a given year. The Work Group is operating under the directive from the Revenue Committees that recommendations for law reform should be substantially revenue neutral.
- Around 1,000 inheritance tax returns are filed each year in Oregon.
- Over half of the total number of Oregon inheritance tax returns have been for estates between \$1 million and \$2 million; those returns produce approximately $\frac{1}{4}$ of the biennial inheritance tax revenue.
- Oregon's inheritance tax presently is a complicated graduated rate with a range of 6-16% that uses two schedules (there really isn't a rate because the tax is linked to the old 2000 federal estate tax credit that was available).
- Presently, an estate under \$1 million pays no tax, while an estate over \$1 million begins paying tax at a 41% marginal rate, which is significantly higher than the 6.4% Oregon inheritance tax rate applicable to the same values. As a result an estate slightly over \$1 million pays over \$30,000 in tax on the entire taxable estate. This is a confusing tax result, and the "steep ramp" is perceived as unfair and it creates significant incentives to manage estates in a way that avoids the \$1 million threshold.

- Oregon and Washington are the only states in the western United States with an estate tax. Washington has a \$2 million threshold, tax rates are 10-19%, and Washington uses a ramp structure (tax on dollars over the threshold only).

PRELIMINARY RECOMMENDATIONS:

The Inheritance Tax Work Group has made several recommendations that are now being integrated into a bill amendment, prepared by Deputy Legislative Counsel, Kate Tosswill. The amendment and recommendations from the Work Group will be presented to the Oregon Law Commission on March 28, 2011. Thereafter, the Commission's recommendations will be presented to the Legislative Assembly. The bill before you is the draft as it is existed on October 28, 2010.

The following represents a summary list of key substantive law changes that the group will recommend to the Oregon Law Commission for its final review, before submission of the recommendations to the legislature.

Estate Tax, No Longer Inheritance Tax

1. Use the right terminology throughout ORS Chapter 118 and call the tax what it is—an estate tax and NOT an inheritance tax (it is the estate that is taxed, not individual inheritance beneficiaries). (Changes made throughout the bill.)

Federal Connection, but Oregon Threshold

2. Decouple from the old 2000 federal estate tax code and reconnect to a newer and more readily available version for most definitions and the basic federal tax structure. Now that Congress passed H.R. 4853 on December 17, 2010, the bill will use a tie-in date of December 31, 2010. See Section 2 and Section 3 (ORS 118.010(2) deleted).
3. Rather than track the federal estate tax threshold, maintain an Oregon-specific estate size that will trigger Oregon's tax. Oregon's threshold is presently \$1 million. The 2009 federal threshold was \$3.5 million; there was no federal estate tax in 2010; the new 2011 threshold is \$5 million. The current bill draft would raise the Oregon threshold to \$1.5 million. See Section 3 and Section 8.
4. Add a new "adjusted gross estate" definition which means the federal gross estate with the federal 2053 (administration expenses) and 2054 (losses) deductions and use that throughout the law. Use a consistent "Oregon taxable estate" term as well throughout the estate tax chapter. See Section 1 and Section 3.

Tax Rate Computation

5. Set and codify Oregon's own estate tax rates and no longer rely on the 2000 federal tax code allowable credit as the state rate that is computed by reference to two complicated outdated tax schedules. See Section 3.

6. Make more reasonable the tax computation process by taxing dollars over the Oregon threshold only (ramp structure), instead of taxing the entire estate if it is over the threshold (present wall). See Section 3.
7. Keep a graduated rate rather than a flat rate, but strive to keep the top rate competitive with Washington (the only Western state with an estate tax). Bill draft uses a rate range of 8.6% to 19.6%. See Section 3.

Marital Property

8. Maintain but clarify Oregon's Special Marital Property provisions. See Sections 3 and 4. Property may continue to be passed on to a surviving spouse with a deferred tax by making the special marital property election. Revises requirements to qualify to follow applicable Uniform Trust Code definition of "permissible distributee".
9. Make cleanup adjustments so that spouses and domestic partners are treated equally throughout ORS Chapter 118 according to Legislative Counsel drafting protocols. (No substantive changes are intended.)
10. Fix the use of the word "distribution" in ORS 118.016 so as to cover all possible property interests. See Section 5.
11. Move the substantive provisions of OAR 150.118.010(7) into the ORS. Namely, clarify that an executor may make separate elections for state estate and federal estate tax purposes. That is, one can make a federal marital deduction (and QTIP) AND also a state QTIP or an Oregon special marital property election for the same property—the elections should be treated as separate elections with different requirements. See Section 3. Clarify when marital property previously claimed must be added back into the Oregon taxable estate.

Intangible Property

12. Recommend no longer taxing intangible property held by the estates of nonresident decedents. The workgroup considered the definitional complexities of determining how to tax entities owned by a nonresident which owned property in multiple states, and concluded that it was too difficult to adopt laws and regulations which would fairly and accurately define the property that is included as well as the property excluded. The enforcement of a law taxing intangible property of a nonresident is administratively very difficult, and it is a very unlikely source of income for Oregon. See Section 3.
13. Recommend removing the confusing reciprocal exemption of intangible personal property provision in ORS 118.010(4)(b) and OAR 150-118.010(4)(b). See Section 3.
14. Do not tax intangible property of resident's Oregon taxable estate if that same property will be taxed in another state. See Section 3.

Natural Resource Property

15. Provide for a revised natural resource property credit with a clarified definition of natural resource property that includes real property and personal property of a farm, fishing, or forestry business. See Section 7.
16. Cap the natural resource property credit that can be taken at \$6 million.
17. Reverse the present administrative rule, OAR 150-118.140(2), and provide that an estate can take a credit for Oregon natural resource property on the state return for qualifying property even if the estate used a marital deduction for the same property on the federal return to defer federal estate taxes. That is, one is NOT bound by federal elections on the Oregon return in this special overlap area of natural resource property and marital deductions. This ensures that every Oregon estate will have a true opportunity to use the natural resource property credit, not just the second spouse. See Section 3.
18. Eliminate “working capital” within the natural resource property concept and instead provide for an “operating allowance” within the definition of “natural resource property.” See Section 7. Place a limit on the operating allowance of cash and cash equivalents that an estate can claim for the credit at the lesser of 20% of the other natural resource property for which a credit is made or \$1.5 million. The operating allowance would have the same restrictions as real and personal property claimed as part of the natural resource property credit, i.e. must be used/available for at least 5 of the next 8 years.
19. Provide that *personal* property elected as natural resource property is subject to the future use requirement and must not be converted during the 5 out of 8 years period, i.e. requires expansion beyond just real property for the look forward requirement. See Section 7.
20. Provide that real property or personal property that was elected for a natural resource property credit can be replaced with other qualifying property and does not cause a disposition with additional tax due. However, bill requires that real property may only be replaced with qualifying real property, and it must be replaced within one year (except for involuntary conversions that have two years). See Section 7.
21. Revise the qualifications for the natural resource credit to require the following: 1) gross estate may not exceed \$15 million; 2) 50% of the gross estate must be natural resource property; 3) the natural resource property claimed is transferred to a family member; and 4) during 5 out of the 8 years prior to the decedent’s death, the decedent or a family member operated a farm, fishing or forestry business and the property for which a credit is claimed is part of that business. See Section 7.
22. Clarify look back requirement. Require that real property claimed for the credit must be owned for 5 out of 8 years prior to decedent’s death. Allow tacking for real property exchanges. Do not impose look back requirement on personal property.

23. For fishing business qualification for the natural resource credit, decedent must have owned a vessel used for commercial purposes, held a boat license, held a commercial fishing license, and held one or more restricted fisheries permits as provided in ORS Chapter 508 for 5 out of the 8 years prior to the decedent's death.
24. Codify OAR 150-118.140(5)(b) which provides that payment of federal estate taxes or state inheritance taxes is NOT an expense incurred in operation of the natural resource business.
25. Require identification of property for which the credit is taken in a statement filed with the return and require heirs to file an annual report of the natural property with the Department of Revenue until the five year requirement is met.
26. Provide for tax due date for additional tax if there is a disposition of the natural resource property or it is not used before the 5 year requirement is fulfilled. Due date set at 6 months after the date on which the disposition or event occurs. See Section 7. Clarify circumstances that will result in additional tax being due.
27. Revise definition of trust property that qualifies for natural resource property by utilizing "qualified beneficiary" definition from Uniform Trust Code.

Interest Issues

28. An Oregon estate which is subject to federal estate taxes and qualifies under IRC 6166 may elect to defer the payment of federal estate taxes. When a Section 6166 election is made, federal law allows a reduced interest rate on the federal taxes owed: 2% on \$1,000,000 of value and 45% of the underpayment rate (currently under 2%) on the balance. However, an estate electing to pay the Oregon inheritance tax on a deferred basis pays the normal Oregon deficiency interest rate (currently 5%) (this is consistent with the Oregon statutes as currently drafted), and a 4% penalty delinquency rate applies as well starting 60 days after the ODR assesses the tax (to raise the current rate to 9%) even if all payments are made by the due dates established when the election is made. The proposed legislation would remove the enhanced interest penalty when the executor of estate has gotten an extension to pay from the Oregon DOR under ORS 118.225 (after application and providing security). See Section 12.
29. Provide in statute that no interest is payable by the state on overpayments of estate taxes until 45 days after the due date of the return, or in the case of a return filed after the due date, no interest is due until 45 days after the date of filing. This change parallels the federal law model for interest and stops Oregon from paying interest that is potentially higher than an investor would receive at a bank.

Oregon Department of Revenue

30. Since Oregon can no longer rely as much on the auditing of the IRS for estate tax compliance (due to the gap between Oregon's threshold and the federal estate tax threshold), the Work Group recommends providing more resources to Oregon Department of Revenue to assist with compliance and auditing.

31. Provide for a statute of limitations in the estate tax chapter – three years to give notice of deficiency; five years for undervaluing the gross estate; and no statute of limitations for false or fraudulent returns.

Cleanup

32. Remove vestiges of the old gift tax that still are lingering in Chapter 118. See e.g. Section 8. Will delete ORS 118.240, etc.
33. Codify a due date for paying Oregon's estate tax for estates that are smaller than the federal threshold and thus have no federal tax due, but still have an Oregon tax due. Section 6(1) and Section 10. Present statute reads as if there is no Oregon estate tax due when there is no federal estate tax due, and that is inaccurate. Due date is 9 months following the date of death of the decedent.
34. Clean up statutes and terms for consistency and clarity throughout and move some substantive administrative rule provisions into statute. Improve readability throughout ORS Chapter 118.
35. Repeal outdated and duplicative provisions.
36. Codify requirement for substantiating values for property on estate tax return and require attachment of any appraisals.

NEXT STEPS:

Having worked through the estate tax issues, the work group will submit its recommendations to the Law Commission on March 28, 2011 for approval. The Commission will then submit its recommendations to the Legislative Assembly.

CONTACT:

- All Commission meetings are public meetings, and thus those interested in the discussion are welcome to attend in person or by phone.
- Past meeting materials, work group membership, and research materials are available on the Commission's website at: http://www.willamette.edu/wucl/olc/groups/2009-2011/inheritance_tax/index.php
- If you would like to get on the email mailing list of the work group and receive meeting notices, meeting summaries, research materials, etc., please contact the Law Commission's legal assistant, Lisa Ehlers at lehlers@willamette.edu or 503-370-6973.
- The Commission's offices are at Willamette University College of Law, 790 State Street, Salem, OR (just across the street from the capitol's west end).

