MEASURE: HB 2541
EXHIBIT: E
HOUSE REVENUE COMMITTEE
DATE: 4/6/2011 PAGES: 27
SUBMITTED BY: OREGON LAW COMMISSION

OREGON LAW COMMISSION

245 WINTER STREET SE
SALEM, OREGON 97301

PHONE 503-370-6973
FAX 503-370-3158
www.willamette.edu/wucl/olc

The Oregon Law Commission is housed at the Willamette University College of Law, which also provides executive, administrative and research support for the Commission.

INHERITANCE TAX

Work Group Report

HB 2541

Prepared by:

Wendy Johnson

Willamette University College of Law

Deputy Director & General Counsel, Oregon Law Commission

From the Offices of the Executive Director

Jeffrey C. Dobbins and

Deputy Director

Wendy J. Johnson

Approved by the Oregon Law Commission at its Meeting on March 28, 2011

I. Introduction

This explanatory report is written to accompany the provisions of House Bill 2541 as amended with the -5 amendment. The introduced pre-session filed bill reflected the work of the Inheritance Tax Work Group of the Oregon Law Commission as it stood in October 2010. The changes to the bill made after October 2010 were so great that amending the original bill was not feasible. Thus, the -5 amendment is a complete "gut and stuff" of the original bill, and this report is an explanatory report of the amendment. The -5 amendment is effectively referred to in the report as "the bill." This report provides background information that led to this bill, explains policy changes that are made in the bill, and provides a section-by-section analysis of the bill.

II. Statement of the Problem

Oregon's inheritance tax statutes, found in ORS Chapter 118, are tied heavily to the outdated 2000 federal Internal Revenue Code. Using such a structure is awkward and has created both administrative and tax policy problems. In addition to being outdated, Oregon's state estate tax chapter is perceived as being overly complicated. The chapter was never originally intended to serve as a stand-alone code, but rather it was viewed as a supplement to the federal Internal Revenue Code during the time of the pass-through estate tax credit. Congress' continual amendments exacerbate the problems with Oregon's estate tax chapter. The Oregon legislature has tried in the past to address two areas of particular equity concern – those include marital property and natural resource property. In those two areas, Oregon has stepped away from the federal approach and created its own provisions, but problems with those provisions have continued to arise. In particular, the "working capital" provision of the natural resource credit has been under continued review and amendment and is perceived as still not functional. In addition to the general complexity and interpretation problems with many of the estate tax provisions, taxpayers are also frustrated that they can't easily figure out what their estate will owe in state estate taxes at their death. This problem exists because there is not a rate table in Oregon law. Instead, Oregon's state estate tax is tied to a complicated graduated rate that is found in the 2000 Internal Revenue Code. The 2000 rates are based on the state estate tax credit that has been repealed for more than 6 years. In addition, because of this tie to the old allowable federal credit, there is an odd wall effect that taxes decedents just over the Oregon threshold at perceived overly high rates. Lastly, in recent years, Oregon's estate tax chapter has been amended virtually every session. Amendment upon amendment over the years has created quite a mess and a comprehensive review of the state inheritance tax law and policy is long overdue.

III. History of the Project

After the 2009 legislative session[1], led by Representative Vicki Berger, the Legislative Revenue Office and several legislators, including the chairs and other members of the House and Senate

[1] HB 3305 was debated in Committee at length during the 2009 session, but it ultimately died in the House Revenue Committee. Among other things, it would have revised the working capital definition, revised the available natural resource property credit, and provided that federal elections were not binding on the state estate tax return.

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. Specifically, legislative leadership gave direction to the Commission to approach a law reform project in a two step process. First, the Commission's Work Group was asked to evaluate the state's inheritance tax system and determine its own scope—either to take a narrow approach and focus largely on the estate tax Natural Resource Credit (NRC) or take a broad approach, looking at the whole inheritance tax chapter.

The Commission approved the law reform project in September 2009 and appointed a Work Group.[2] The Work Group was chaired by Commissioner Lane Shetterly and was composed of

[2] The membership of the Work Group included the following persons:

MEMBERS:	
Lane Shetterly	Oregon Law Commissioner, Work Group Chair
Clint Bentz	CPA, Boldt, Carlisle & Smith LLC
Judge Henry Breithaupt	Judge, Oregon Tax Court
Jeff Cheyne	Attorney, Samuels Yoelin Kantor Seymour & Spinrad, LLP OSB Estate Planning Section Representative
Brian Haggerty	Attorney, Minor Bandonis & Haggerty PC OSB Elder Law Section Representative
Jonathan Mishkin	Attorney, Harrang Long Gary Rudnick PC OSB Business Section Representative
Jeff Moore	Attorney, Saalfeld Griggs PC
Terrance O'Reilly	Law Professor, Willamette University College of Law
Katherine VanZanten	Attorney, Schwabe Williamson & Wyatt OSB Tax Section Representative
ADVISORS:	
Debra Buchanan	Legislative Coordinator, Oregon Department of Revenue
Shawn Cleave	Governmental Affairs Specialist, Oregon Farm Bureau
Debbie Koreski & Alyson Kraus	House Speaker's Office Staff
Chuck Mauritz	Attorney, Duffy Kekel LLP

members, advisors, and interested persons who have expertise in accounting, estate planning, elder law, estate taxation, business entity law, natural resource interests, public policy, the Oregon Department of Revenue, and state politics. The Work Group also has had the assistance of the Legislative Revenue Office and Legislative Counsel. The Work Group met at least monthly from October 2009 to March 2011.

At the first meetings, the Work Group discussed the scope of the law reform project and chose to take a broad approach as it determined that the problems associated with the Natural Resource Credit could not readily be addressed without addressing structural problems with the inheritance tax chapter itself. Special subgroups were also formed throughout the process and met to focus on complex issues regarding natural resource property, marital property, and intangible property.

Tim Nesbitt	Deputy Chief of Staff, Governor's Office
Steve Robinson	Policy Analyst, Oregon Center for Public Policy
Jeff Stone & Patrick Capper	Director of Government Relations, Oregon Association of Nurseries
INTERESTED PERSONS: Alice Bartelt	League of Women Voters of Oregon
Keith Kutler	Assistant Attorney General, Oregon Department of Justice
Scott Nelson	Attorney, K&L Gates LLP
David Nebel & Matt Shields	Public Affairs Attorney, Oregon State Bar
Jody Wiser	Tax Fairness Oregon
Peggy Woolsey	Tax Fairness Oregon
Staff: Jeffrey Dobbins	Executive Director and Law Professor, Oregon Law Commission and Willamette University College of Law
Wendy Johnson	Deputy Director and General Counsel, Oregon Law Commission
Mazen Malik	Senior Economist, Legislative Revenue
Kate Tosswill	Deputy Legislative Counsel, Legislative Counsel's Office

IV. History of Inheritance Tax Law in Oregon

Oregon has had an inheritance tax since 1903.[3] Beginning in 1971, Oregon maintained its own inheritance tax but also imposed an additional tax that was based on the state tax credit that was allowed on the federal return. After a ten year phase out,[4] in 1987, the only estate tax Oregon imposed was the allowable credit on the federal return (i.e. the pass-through tax). In addition, for several decades now, Oregon's estate tax chapter 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 the federal estate tax return for state estate taxes paid. Thus, during that time period, Oregon's state estate taxes had very little burden on many tax payers because the federal credit effectively provided a pass-through to Oregon of estate tax money that otherwise would have gone to the federal government anyway.

In 2001, when the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) passed, EGTRRA phased out the credit (i.e. the pass-through) from 2001-2004. And in 2005, the credit on the federal return was eliminated and replaced with a deduction for state estate taxes paid. This new deduction on the federal return (for those with estates large enough that a federal estate tax is owed) computed to giving federal estate taxpayers nearly 50% back of what was paid in state estate taxes. That percentage was lowered beginning with 2010 decedents as Congress lowered the federal estate tax rate to 35% at the end of last year. EGTRRA also raised significantly the filing threshold for paying federal estate taxes; the threshold increase was phased in, moving from $1 million to $3.5 million in 2009. Thus, fewer Oregon residents are paying a federal estate tax, and only those in the upper estate size brackets get the federal deduction.

For over 75 years, most states set their state estate tax rate as the maximum allowable credit on the federal return. When the credit was repealed in 2005, if states wanted to continue to receive estate tax revenues, most states (including Oregon), needed to decouple from the newer federal code since the credit provision had been repealed. Twenty-eight states decided to repeal their estate tax altogether and just forgo the state revenue. Initially, almost all of the other states opted to just amend their statutes and stay linked to the pre-2001 federal code and not connect to the new federal code, thereby still calculating the tax using the old credit chart as the tax. In 2003, Oregon too opted to stay connected to the 2000 federal estate tax code, instead of reconnecting to the new code.[5] In subsequent sessions, the legislature continued to make amendments to the Oregon inheritance tax, but remained connected to the 2000 federal code.

---

[3] The inheritance tax then was a range of 1-6% that was based on the recipient's relationship to the decedent and the amount of property received. The rate was higher for collateral relatives than for lineal descendants and was even higher for non-relatives.

[4] See Chapter 66, Oregon Laws (1977).

[5] HB 3072 (2003), Section 2.

The Oregon legislature did diverge from the federal code and adopted its own modified state QTIP provision known as Oregon State Marital Property in 2005[6] and its own Oregon Natural Resource Property Credit in 2007[7]. 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.

Most recently, the federal estate tax expired and there was no federal estate tax for the 2010 year. However, on December 17, 2010, after much Congressional debate and amendments, President Obama signed H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and it became effective. Sections 301-304 of that Act provided for temporary estate tax relief provisions. Most notably, the Act retroactively reinstated the estate tax for decedents dying in 2010, but reduced the maximum tax rate for estates to 35 percent (down from 45 percent rate for decedents dying in 2009). Also, the Act allows executors of the estates of decedents dying in 2010 to elect out of the federal estate tax and instead apply the new federal carryover basis rules enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 to estate property. Also of significant note is that this new federal legislation raised the exclusion (i.e. threshold for size of estate) to $5 million (was $3.5 million), making the gap between the federal and Oregon thresholds even greater.

V. Inheritance Tax Revenues

Oregon inheritance tax revenues currently average about $200 million a biennium, and this revenue comes from approximately 2,000 estates. While these numbers are averages, inheritance tax revenues are fairly volatile as revenue depends on who dies in a given year and what their respective estate size is. One very large estate in a given year can skew the average significantly. Presently 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 ¼ of the biennial inheritance tax revenue. The Work Group reviewed estate tax revenue data provided by Legislative Revenue's Office and the Department of Revenue throughout this law reform project.

VI. Scope of the Project

This recommended bill revises ORS Chapter 118 to:

- Disconnect from the outdated 2000 federal Internal Revenue.
- Improve and amend provisions to meet policy objectives.
- Clarify provisions and expound on estate tax areas where there are gaps in the law or procedure.
- Correct mistakes in the estate tax chapter.

[6] HB 2469 (2005).

[7] See HB 3201 (2007), modified by HB 3618 (2008).

VII. Policy Changes Made by Bill

1. Federal Connection with Newer Date, but Oregon Threshold

This bill decouples Oregon's estate tax from the old 2000 federal estate tax code and reconnects to a newer federal tax code—the federal code as it existed on December 31, 2010.[8] This new code is readily available to tax professionals and the public. The bill provides that Oregon's estate tax law will continue to rely on the federal code for most definitions and the basic federal estate tax structure. Note that Congress passed H.R. 4853 on December 17, 2010, and thus the tie-in date of December 31, 2010 picks up Congress' latest revisions to the federal estate tax.

Rather than track exactly the federal estate tax code, this bill continues several unique state estate tax provisions but is also drafted so that it is a more of a stand-alone state estate tax law chapter. This will help should Congress continue to amend the federal estate tax code. One of the biggest differences between the federal law and the state law is the estate size threshold. The bill maintains a lower state estate tax threshold than the federal estate tax threshold. Only if an estate is larger than the threshold will there be an estate tax. Oregon's threshold has been at $1 million for 5 years, but this bill would increase Oregon's threshold to $1.5 million.[9] The federal threshold was increased in December 2010 from $3.5 million to $5 million. The threshold increase was not a unanimous recommendation as it did not have the support of the Tax Fairness Oregon representatives.

2. Tax Rate Computation

The Oregon estate tax will no longer be based on the repealed federal state death tax credit from 2000 that references two complicated and outdated tax schedules.[10] Instead, the bill sets and codifies Oregon's own estate tax rates, using a progressive tax with a range of 8.6% to 19.6%.[11] Compared to present law, this rate range provides a slightly lower rate for small estates and a slightly higher rate for large estates (over $5 million). The rates are competitive with Washington's rates and this is noteworthy because Washington is the only western state with an estate tax. Estates over $5 million receive a deduction for the state estate taxes paid on their federal return.[12] Thus, while this bill increases the tax rate for larger estates, the net tax burden is eased. The federal deduction is the state estate tax paid multiplied by the federal estate tax rate; that is, presently, taxpayers get 35 cents on the dollar back on the federal tax bill as the federal

---

[8] See ORS 118.007 as amended.

[9] See ORS 118.010 deducting $1.5 million from the federal taxable estate as part of the calculation to compute the Oregon taxable estate. See also amendment to ORS 118.160, providing that an estate tax return is not required with respect to estates of decedents who die on or after January 1, 2011, unless the value of the gross estate is $1.5 million or more.

[10] See present ORS 118.010(2) repealed.

[11] See new ORS 118.010(4).

[12] See IRS Form 706, Part 2, line 3b.

tax rate is 35% (lowered from 45% in December 2010). The Work Group also considered but rejected a flat or flatter tax rate schedule, in favor of the progressive schedule.

This bill makes more reasonable the tax computation process by taxing only dollars over the Oregon threshold only (ramp structure), instead of taxing the entire estate if the estate size is over the threshold (present wall). The wall effect occurs presently because of the tie to the old federal credit. Under present law, an estate under $1 million pays no Oregon tax, while an estate $1 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 perceived as an unfair tax result that creates significant incentives to manage estates and spend down in a way that avoids the $1 million threshold altogether. Instead of the wall, the bill would tax estates only on those dollars over the $1.5 million threshold. The bill provides for a true 1.5 million exclusion to all estates.

3. Marital Property

This bill maintains but clarifies Oregon's Special Marital Property provisions[13] and clarifies the overlap of an Oregon Special Marital Property election with the federal marital property election provisions found in sections 2056 and 2056A of the Internal Revenue Code. Specifically, this bill solidifies that an executor may make separate elections for state estate and federal estate tax purposes as long as the requirements are met.[14] This had been the practice as an administrative rule had also provided for this right, but the bill codifies this rule. This is important because the federal and state thresholds are so different, and thus taking a marital deduction is an important tool for deferring taxes. The marital deduction allows couples to defer estate tax at the first spouse's death by electing to use the marital deduction. Importantly, the bill also clarifies when the value of marital property previously claimed must be added back into the Oregon taxable estate when the second spouse dies.[15]

4. Intangible Property

This bill provides that Oregon will no longer tax intangible property held by the estates of nonresident decedents.[16] That is, for non-resident decedent estates, only the value of real property and personal property located in Oregon will be subject to Oregon's estate tax.[17] Resident decedents will continue to be taxed on their intangible property (wherever it is located),

---

[13] See ORS 118.013 and 118.016.

[14] See ORS 118.010(8) as amended and OAR 150-118.010(7).

[15] See ORS 118.010(3)(a)(B) as amended.

[16] See present ORS 118.010(4)(a) ("intangible property located in Oregon " deleted) and present ORS 118.010(4)(b) deleted.

[17] See new ORS 118.010(6).

unless it is subject to a death tax in another state or country.[18] The reasons for no longer taxing intangibles of nonresident decedents include the following: 1) it is tremendously complex and impractical to try to define what types of intangibles Oregon would tax because by definition intangibles do not have a readily ascertainable location; 2) taxes from intangible property provide little revenue to the state; 3) such a tax is nearly impossible to enforce due to the often complex ownership interests involved; 4) no other western state taxes the intangibles of nonresident decedents' estates; 5) there is a potential state business investment disadvantage with trying to tax such intangibles; and 6) it is easily susceptible to double taxation and litigation because unlike real property and personal property, the location of an intangible is often difficult to determine.[19] The workgroup considered trying to tax the value of an intangible in an estate if there was some percentage of real property ownership in Oregon that was part of the intangible, but the group determined that very arbitrary lines would need to be drawn, it would require looking through entities in ways that are not practical, and there were easy ways for taxpayers to avoid the requirements. In the end, the Work Group concluded that taxing intangibles for non-residents just would not work.

To complete this policy change, the bill repeals the confusing reciprocal exemption of intangible personal property provision in present ORS 118.010(4)(b) and deletes the phrase "and intangible personal property located in Oregon" in present ORS 118.010(4)(a). The administrative rule, OAR 150-118.010(4)(b), will also need to be repealed. The reciprocal provision had long lost its meaning and become the subject of confusion because more and more states have no effective estate tax due because of the repeal of the state estate credit but still have an estate tax in their law. Lastly, the bill deletes confusing "within the jurisdiction of the state" language in ORS 118.010(1) and instead the bill focuses on domicile of the decedent and location of the property of the decedent to determine what property is subject to Oregon's estate tax.

5. Natural Resource Property

a. Definitions

This bill substantially rewrites to clarify and improve the existing natural resource property credit for farm, fishing, and forestry businesses by providing definitions for each of these businesses and also by expounding upon the definition of natural resource property.[20] Present law provides a credit for both real and personal property used for farm, forestry and fishing businesses,[21] but the definition of "natural resource property" is presently only focused on real

---

[18] See new ORS 118.010(5).

[19] Unlike real property and personal property, there is no constitutional protection from multiple states taxing the same intangible property. Texas v. Florida, 306 U.S. 398, 410 (1939).

[20] See new ORS 118.140(1)(b) (defining "farm business"), new ORS 118.140(1)(d) (defining "fishing business" the same way as it is defined in existing ORS 118.140(2)(a)(B)(i)), and new ORS 118.140(1)(f)(defining "forestry business"). See also expounded "Natural resource property" definition in new ORS 118.140(1)(h).

[21] See existing ORS 118.140(2)(a).

property.[22] The bill revises the definition of "natural resource property" to include both real property and personal property (tangible and intangible). This item is listed here as a "policy" change because it effects the other policy changes concerning the natural resource credit. It really is a technical change, though.

b. Formula for Credit and Cap on Credit

The bill provides a new formula[23] for calculating the natural resource credit and repeals the existing credit schedule.[24] The existing schedule is odd in that the schedule provides for claims of natural resource property up to $15 million, but no professional would ever advise a claim greater than $7.5 million due to the decreases in the credit that the schedule provides for claims over $7.5 million. The present curve in the schedule, which increases and then decreases, simply does not work well in practice as present law also allows estates to claim a partial credit.[25] The present schedule raises equity concerns as well.

After the Oregon estate tax is computed,[26] the bill's new formula gives a credit based on the percentage of the adjusted gross estate that is claimed natural resource property. This new formula focuses on the ratio of natural resource property compared to the adjusted gross estate rather than focusing solely on the amount of natural resource property claimed. This calculation is quite easy. However, Legislative Revenue staff found based on modeling that this new formula does provide a net larger credit than the present law. A more revenue neutral formula was presented and rejected, largely because of its complexity.[27]

---

[22] See existing ORS 118.140(1).

[23] See new ORS 118.140(2)(b).

[24] See existing ORS 118.140(2)(c).

[25] That is, as originally drafted, to qualify for the credit, at least 50% of the adjusted gross estate had to be natural resource property and the estate had to actually claim the full amount. The curve worked under that system, but does not function when estates are allowed to take a partial election and elect property for the credit asset by asset. Large estates will choose the maximum benefit, and only claim $7.5 million in natural resource property. See existing ORS 118.140(2)(b) and new ORS 118.140(2)(c) (both allowing for partial credit).

[26] Note that the tax rate is based on the Oregon taxable estate before the credit. Thus the formula builds into it a higher tax rate for larger estates than for smaller estates. See new ORS 118.010(4).

[27] The more revenue neutral formula suggested by Legislative Revenue makes an adjustment and would provide: The credit allowed under this section shall be computed by multiplying the tax payable under this chapter by both Ratio A and Ratio B, where:

A) Ratio A is a ratio of the lesser of the amount of natural resource property claimed or $7.5 million, over the amount of the total adjusted gross estate, and

B) Ratio B is a positive ratio in which the numerator is equal to the amount of natural resource property claimed less $1.5 million, but not less than zero, and the denominator is equal to the total adjusted gross estate less $1.5 million.

Note that (A) ratio is the same formula used in the -5 amendment (see new ORS 118.140(2)(b)) but with a higher cap and that the (B) ratio is the adjustment.

This bill also effectively caps the value of natural resource property for which an executor is allowed to elect the natural resource credit upon at $6 million.[28] This is $1.5 million less than the present effective cap, but the bill makes this change because all estates will enjoy a true $1.5 million exclusion under the bill.[29] In addition, the work group recommended this lowering of the cap to address some of the revenue impact loss. However, the bill's new credit formula will reduce the overall revenue from the estate tax[30] as it does provide a larger credit than present law provides, and this is a policy concern.

c. Overlap with Federal Marital Deduction

This bill provides in statute that an estate can take a credit for Oregon natural resource property on the state return for qualifying property, despite using a marital deduction for the same property on the federal return. That is, the bill provides that an executor is not bound by federal elections on the Oregon return in the overlap area of natural resource property and marital deductions.[31] This is a policy change from the existing Department of Revenue administrative rule[32] (the present statute does not speak to the issue). This policy change ensures that every Oregon estate will have a true opportunity to use the natural resource property credit, not just the second spouse. Presently, the first spouse will generally take a marital deduction on the federal return due to the high federal tax rate. If that election is made, the natural resource credit on the Oregon return cannot be made.

d. Working Capital Changed to Operating Allowance

This bill repeals the term "working capital"[33] within the natural resource property credit provision and instead provides for an "operating allowance" within the definition of "natural resource property."[34] The bill also defines "operating allowance" instead of leaving it to be defined by administrative rule as "working capital" is presently. The bill defines "operating allowance" as "cash or a cash equivalent that is spent, maintained, used or available for the operation of a farm business, forestry business or fishing business and not spent or used for any other purpose."[35] The work group discussed this issue at length and determined that it was not

---

[28] See revised ORS 118.140(2)(b).

[29] See revised ORS 118.010(3)(b).

[30] On average, only about 35 estates per year make a natural resource property election (and that number could decrease by about 1/3 with lowering the exclusion to $1.5 million) and thus determining the revenue impact of any credit formula involves some speculation and actual estate tax revenues are subject to volatility (who dies and what the estate value is) each year.

[31] See revised ORS 118.010(8).

[32] See OAR 150-118.140(2).

[33] See repealed ORS 118.140(2) (a)(D).

[34] See new ORS 118.140(1)(h)(I) (including operating allowance within definition of natural resource property).

[35] See new ORS 118.140(1)(i).

practical to try to keep a "working capital" concept because the plain meaning of that term is current assets minus current liabilities. To arrive at such a number would require an individualized and complicated accounting exercise for each estate. In addition, a big problem was that the growing cycle for timber, animals, crops, etc. can vary a great deal. Thus, the time frame chosen from which to calculate the cash on hand for working capital would greatly influence how much working capital could be elected. In the end, the group concluded that the goal is really to allow an estate with a farm, forestry, or fishing business to claim a reasonable amount of cash or cash equivalents on hand as natural resource property if it will be used for the farm, forestry, and fishing business. That is, many such businesses operate on debt, but those who do operate with cash should be able to count it as part of the electable natural resource property.

The work group decided to put a couple safeguards in the bill to prevent abuse of the operating allowance provision. The two safeguards include the following: First, the operating allowance will be subject to the same disposition rules as other elected property, and thus an additional tax due will be due if the operating allowance is not used for the farm, forestry, or fishing business for the required five year period.[36] The group reasoned that requiring that the elected operating allowance be tracked and used for the business for five out of the next eight years, will cause many to not elect or at least not elect too much operating allowance. Heirs often do not want to "lock up" cash. Second, the bill places a limit on the operating allowance of cash and cash equivalents that an estate can claim for the credit as the lesser of 20% of the other natural resource property for which a credit is claimed or $1.5 million.[37] This limit helps ensure that the ratio of cash to other elected property is reasonable. The 20% choice is not any "magic number", but rather a compromise that represents what the work group considered reasonable and workable. Sometimes it could be argued that 20% will allow a particular estate to elect too much cash and cash equivalents, but other times, the 20% may be too small. A death may occur just after a crop has been harvested and before it has been reinvested back into the farm, forestry or fishing business. Depending on the commodity or product, the amount of cash on hand could be a very large percentage of the natural resource property. The group consulted some agriculture experts, but none could help give a more precise percentage suggestion for what to allow for operating allowance. In the end though, the group felt very comfortable recommending the lesser of 20% of the other natural resource property for which a credit is made or $1.5 million.

e. Replacement Property

This bill provides explicitly that real property and personal property that was claimed for a natural resource property credit can later be replaced with other qualifying natural resource property without causing a disposition with additional tax due.[38] For example, the work group reasoned that a farmer should be allowed to carry on the business operations and that may mean that he decides to sell a tractor that isn't needed anymore. However, if the value of the tractor

---

[36] See new ORS 118.140(9)(a).

[37] ORS 118.140(2)(a) (limiting operating allowance to lesser of $1.5 million or 20% of the total value of natural resource property claimed, not including the operating allowance).

[38] See new ORS 118.140(9)(d).

was claimed under the natural resource credit, the proceeds of that tractor sale need to be used in the business—perhaps to purchase another tractor, buy seed, etc. The proceeds cannot be converted out of the business. The issue of replacement is silent in present law. The Department of Revenue expressed concern about the lack of guidance on this issue and thus the bill is explicit regarding the requirements. The Work Group considered using the 26 USC 1031 procedures for like-kind exchanges, but in the end, the group reasoned application of those federal provisions were not necessary because the bill's own definitions could be utilized instead. The bill provides that property can be replaced as long as the replacement property also meets the bill's definition of "natural resource property." In addition, the bill requires that elected property must be tracked on an annual report with a confirmation that elected property is either still in use, has been replaced with qualifying property, or has been subject to a disposition.[39] Legislative history shows that the natural resource credit was originally focused only on real property (i.e. the land), but personal property was quickly added. Allowances for replacement seem less important with real property than with personal property that can wear out quickly. That fact explains perhaps why the present law is silent on replacement as the issue probably wasn't raised initially. While the bill does allow replacement of real property, the bill requires that elected real property may only be replaced with qualifying real property, and to avoid additional tax, the real property must be replaced within one year (except for involuntary conversions that have two years).[40] The group reasoned that it was protection of the family farm and forestry business and the respective land base for those businesses that was the primary motivation for the legislature's creation of the natural resource credit. One shouldn't be able to replace the land for cash, etc. as this would invite abuse of the credit. The bill provides that personal property can be replaced with any kind of other qualifying natural resource property, including real property, personal property, and operating allowance. This bill fills the void in the law and addresses replacement issues both prior to claiming the credit and after the credit is claimed.[41]

f. Consistency in Look Forward Requirement

This bill treats all types of elected natural resource property the same for the look forward requirement. That is, any elected natural resource property is subject to additional tax if it is not used in the operation of the farm, forestry, or fishing business or if it is transferred (i.e. converted) to a nonqualified person.[42] Present law is confusing and does not appear to put the future use requirement on elected personal property or the "working capital," instead putting the look forward requirement only on real property.

g. Look Back Requirements

This bill clarifies and revises the look back requirements. First, the bill provides that a natural resource credit may be claimed only if during the five out of eight years prior to the decedent's

---

[39] See new ORS 118.140(10) and the paragraphs within that subsection.

[40] See new ORS 118.140(9)(d).

[41] See new ORS 118.140(4)(c) and (9)(d).

[42] See new ORS 118.140(9)(a).

death, the decedent or a family member operated a farm, forestry, or fishing business and the property for which a credit is claimed is part of the business.[43] Due to the bill's new definitions in ORS 118.140, these changes and clarifications that focus on the business were possible; the group believes this approach addresses the policy intent of protecting family businesses better. The present law seems to require ownership of all property for which the credit is claimed for five out of the eight years prior to the decedent's death. Such a requirement does not make sense for personal property or operating allowance as personal property is often not durable and is changing in the business and cash and cash equivalents are also in constant flux. For example, crops are generally sold each year and equipment is often replaced before five years. The bill would remove any look back requirement for personal property. Instead, this bill imposes a look back requirement only on the real property by providing that real property may be claimed for the credit if it was owned by the decedent or a family member for 5 out of 8 years prior to the decedent's death and the real property must have been used in a farm or forestry business.[44] This requirement was intended to prevent land grabs prior to death and other unintended behavior persons may make to qualify for the natural resource credit. The group foresaw two potential unintended consequence by requiring real property ownership for five out of eight years, and that is the exchanged property and involuntarily converted property situations. For example, a farmer may have farmed for the five years but shortly before the decedent's death the farmer exchanged the north 40 acres for the south 40 acres. This bill allows for limited tacking for meeting the five year ownership requirement. The bill provides that when property was received in an exchange under section 1031 of the Internal Revenue Code or acquired in an involuntary conversion under section 1033 of the Internal Revenue Code, the period of time of ownership of the exchanged or acquired real property may be included if it was also used in the farm or forestry business.[45]

h. Fishing Business Qualifications

Present law allows a natural resource credit for the value of listed fishing-related property if the decedent or family member was licensed under ORS Chapter 508.[46] Present law requires the following additional qualifications for the credit based on having the fishing license: the value of the fishing property must be at least 50% of the total adjusted gross estate, the adjusted gross estate may not exceed $15 million, and the fishing property must be transferred to a family member. Unlike the farm and forestry business qualification provisions, present law requires no look back for fishing property to qualify and no real operation of a fishing business. The bill tightens up this area of the law by requiring operation of a fishing business. In addition, the decedent or a family member must have owned a vessel used for commercial fishing purposes, held a boat license, held a commercial fishing license, and held one or more restricted fisheries permits as provided in ORS Chapter 508.[47] Each of these new qualifications must have been

[43] See revised ORS 118.140(3)(d).

[44] See new ORS 118.140(5).

[45] See new ORS 118.140(7).

[46] See present ORS 118.140(2)(a)(B)(repealed under bill). Note that Chapter 508 provides for many types of licenses, many of which are not commercial licenses. The Work Group recommends further specificity in the bill.

[47] See new ORS 118.140(6).

maintained for 5 out of the 8 years prior to the decedent's death.[48] Such new requirements prevent death bed purchases and seem to provide an estate tax break for those true fishing businesses that the law seems to have been intended to cover. In addition, these requirements are consistent with the natural resource credit qualifications for farm and forestry businesses.

i. Accountability and Disposition Clarity

The Work Group identified an enforcement problem with the natural resource credit under current law. Both present law and the bill require the executor of an estate to make the natural resource credit election and also notify the transferee (heir) of the potential for tax consequences to the transferee if there is a later disposition of the property they received.[49] That is, if the heir causes a disposition of the natural resource property (for example, by selling it) and doesn't complete the five year requirement, an additional tax will become due. That additional tax is the responsibility of the heir of the natural resource property at the time of the disposition.[50] The problem under existing law is that there is no required tracking of the elected natural resource property once the estate tax return is filed. In addition, the language defining what triggers the additional tax is unclear, and there is no due date for the additional tax. The present law really is a very loose honor system that is nearly impossible for the Department of Revenue to track or enforce. This bill spells out what events will cause a disposition.[51] The bill specifically provides that payment of federal estate taxes or state inheritance taxes is not an expense incurred in operation of the natural resource business.[52] As explained earlier, the bill clarifies that natural resource property that is replaced with qualifying natural resource property will not cause a disposition.[53] This bill also imposes a new tracking provision by requiring the executor to file a statement with the estate tax return that identifies the property for which the natural resource credit is claimed.[54] After the return is filed, the bill then turns the tracking responsibility over to the transferees, by requiring the transferees (heirs) of the natural resource property to file an annual report of the natural resource property with the Department of Revenue until the five year requirement is met.[55] This annual report requires tracking of each asset for which the credit was claimed with confirmation that each asset falls into one of three categories: 1) the asset is still used in the operation of the a farm, forestry, or fishing business; 2) the asset has been replaced with other qualifying natural resource property; or 3) the asset has been subject to a disposition

---

[48] See new ORS 118.140(6).

[49] See ORS 118.140(7)(c) under present law, renumbered as ORS 118.140(9)(f) under the bill.

[50] See existing ORS 118.140(7)(b).

[51] See new ORS 118.140(9).

[52] See new ORS 118.140(9)(b).

[53] See new ORS 118.140(9(d).

[54] See new ORS 118.140(10).

[55] See new ORS 118.140(10).

and additional tax is due.[56] Finally, the bill provides for the tax due date for additional tax if there is a disposition of the natural resource property or it is not used for the required five years. The bill provides that due date is six months after the date on which the disposition or event occurs.[57]

6. Interest Issues

The bill removes the enhanced interest penalty (known as tier 2 interest) when the executor of an estate has gotten an extension to pay from the Oregon Department of Revenue under ORS 118.225 (after application and providing security) or a bond is given under ORS 118.300.[58] This is in keeping with federal law and addresses the practicalities of estates that do not have liquid assets to pay all of the estate tax due on the due date. For example, an estate that qualifies under 26 U.S.C. 6166[59] for an extension to pay and to use an installment plan to pay receives a reduced interest rate (rather than a penalty rate) on the federal taxes owed. However, under present Oregon law an estate electing to pay the Oregon inheritance tax on a deferred basis pays the normal Oregon deficiency interest rate (currently 5%) and a 4% penalty delinquency rate will also apply starting 60 days after the Department of Revenue assesses the tax (to raise the current rate to 9%), even if all payments are made by the due dates established when the extension was granted. The present law seems inconsistent because on the one hand Oregon law allows for an extension to pay, but on the other hand it still imposes an enhanced interest. This bill would remove the enhanced interest if the extension is granted[60] or a bond is given.[61] The State is protected because to receive an extension, the tax debt must be secured by bond, deposit, or other good collateral acceptable by the Department of Revenue.[62] In the same statute, ORS 118.260, the bill also provides an interest break to the State of Oregon. The bill provides 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.[63] This change also parallels the federal law model for interest. The Department of Revenue explained that an estate presently can file late but provide a timely payment. When the return is actually filed, it may turn out that there was an overpayment. Present law requires the State to pay interest on the refund even though the State could do nothing about the overpayment until the estate tax return was filed. The State of Oregon presently ends up acting as a bank

---

[56] See new ORS 118.140(10).

[57] See new ORS 118.140(9)(e).

[58] See revised ORS 118.260(5)(b), (6).

[59] Provision applies where estate consists largely of property interests in a closely held business.

[60] See revised ORS 118.260(5)(b) (adding "without regard to ORS 305.222" which is the tier 2 interest).

[61] See revised ORS 118.260(6) (adding "without regard to ORS 305.222" which is the tier 2 interest).

[62] See ORS 118.225.

[63] See revised ORS 118.100(1) and ORS 118.260(7).

because the interest on the refund often is higher than an investor would receive at a bank. This bill addresses the problem by providing that no interest is payable by the State on overpayments of estate taxes until the later of 45 days after the due date of the return (applies to early filers) or 45 days after the date of filing.

7. Oregon Department of Revenue

Since Oregon can no longer rely as much on the auditing of the IRS for state 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. It was noted that the staffing for this section of the Department has been drastically cut over the years. The bill makes no budgeting directives, but the work group agreed to note this need in the report. This bill does provide several directives to the Oregon Department of Revenue to shape their agency work and help enforce the estate tax more effectively. The bill provides 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.[64] Present law provides for conflicting statutes of limitations.[65] The bill codifies 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. Present law inaccurately reads as if there is no Oregon estate tax due when there is no federal estate tax due, and that is inaccurate as the state threshold is lower ($3.5 million lower under the bill and $4 million lower under present law). The bill fixes this mistake and provides that the tax is due to the Department of Revenue nine months following the date of death of the decedent.[66] Another fix the bill makes is to codify the requirement for substantiating values for property on the estate tax return and require attachment of any appraisals. This is done in practice but there is not a present statutory requirement. This mirrors the federal approach and the federal Form 706 requirements. An appraisal is not always required but attachment of an appraisal is the best practice and is common practice. The provision stops short of requiring an appraisal because some circumstances will make it unnecessary. For example, if the property will qualify as special marital property anyway, an appraisal wouldn't make a difference. There have been disputes on valuation and this requirement will both assist the Department and clarify the law for executors. This will assist the department in its enforcement.[67]

---

[64] See bill Section 28.

[65] See ORS 118.171 which provides that the assessment provisions of ORS Chapter 305 apply to Chapter 118. However, ORS Chapter 305 provides no statutes of limitations. See also ORS 118.230(2) which provides that the assessment provisions of ORS Chapter 314 apply to Chapter 118. ORS 314.410 does provide limitations on notices of deficiency and assessment of tax, but it references the income tax. In essence, there does not seem to be an estate tax statute of limitations in existing law.

[66] See revised ORS 118.100(1).

[67] See new ORS 118.100(6).

VIII. Section by Section Analysis

This bill changes the terminology throughout ORS Chapter 118 and calls the tax what it is—an estate tax and NOT an inheritance tax. The tax is correctly referred to as an estate tax because it the estate that is taxed, and not individual inheritance beneficiaries.

Section 1: This section provides the definitions for the chapter. The section adds definitions for "federal taxable estate" and "Oregon taxable estate." The definitions form a type of hierarchy: "Gross estate" is the broadest estate definition as it means the value at the time of death of all of the decedent's real property and personal property, whether tangible or intangible, and wherever it is situated (Oregon or elsewhere). "Federal taxable estate" is the "gross estate" with the permitted federal estate tax deductions. For example, it picks up deductions under section sections 2053, 2054, and 2058 of the Internal Revenue Code. The "Oregon taxable estate" is the federal taxable estate with Oregon state deductions and add-backs. For example, Oregon has a special marital property deduction. This section also deletes three terms and their respective definitions; the deleted terms are "nonresident decedent," "resident decedent," and "transfer". The terms "resident decedent" and "nonresident decedent" are moved to Section 3 of the bill. The term "transfer" was deleted as it was deemed unnecessary and led to confusion with its reference to federal law.

Section 2: This section changes the connection date to the federal Internal Revenue Code to December 31, 2010. By doing so, Oregon will no longer be connected to the outdated code. It also means Oregon's estate tax will no longer be based on the repealed federal state death tax credit and reference to two complicated and outdated tax schedules for calculating its estate tax.

Section 3: This section substantially rewrites ORS 118.010 to set up the framework for Oregon's estate tax. It provides what property will be taxed and which decedents will be taxed. Nonresidents are distinguished from residents and it is the domicile of the decedent that will dictate into which of these two categories an estate falls. All resident decedents are subject to Oregon's estate tax and nonresident decedents are subject to the estate tax only if they have real or personal property located in Oregon. To determine the state estate tax and compute the "Oregon taxable estate," the section provides that you start with the "federal taxable estate" (this is the federal estate with the federal deductions) and then you add back in two deductions. The first is the deduction for state estate, inheritance, legacy or succession taxes allowed under 26 U.S.C. 2058. Second, you add back in the value of property previously deducted as Oregon special marital property or deducted as a separate Oregon election under section 2056 or 2056A of the Internal Revenue Code, unless the same property is already included in the federal taxable estate. Having made the add-backs, the framework next provides for three reductions. The reductions include the value of all special marital property elections, the $1.5 million exclusion, and a catch-all category for "any other exclusions or deductions." With the add-backs and reductions made, the Oregon taxable estate value will be reached. Subsection (4) then provides a tax rate schedule to impose on the Oregon taxable estate. See discussion above under "Tax Rate Computation" heading for more policy explanation. Subsections (5) and (6) then provide a ratio formula to remove the real and personal property located outside of Oregon. Only residents will be taxed on their intangible property and their intangible property is effectively deemed located

in Oregon under the bill.[68] See also discussion above under the "Intangible Property" heading. If the intangible property of the resident decedent will be taxed by another state or country as a result of the death of the decedent, the value of that property may also be deducted from the numerator of the ratio. Subsection (8) provides that an executor may make separate elections for state and federal estate tax purposes with regard to marital property and natural resource property. See above discussion under "Marital Property" and "Overlap with Federal Marital Deduction" headings.

Section 4: This section repeals existing ORS 118.013(1) as that provision relies on the state death tax credit once allowable under the Internal Revenue Code; the credit was repealed in 2005. With the repeal of (1), this statutory provision will now focus on Oregon's special marital property by defining the requirements to qualify a trust or other property interest as Oregon special marital property. The section uses a new term, "permissible distributee" and defines it. That term comes from the Uniform Trust Code[69] passed into law in Oregon during the 2005 session; that term better captures the beneficiaries that should be consenting to property being set aside to qualify as Oregon special marital property. The present phrase in ORS 118.013(3)(b) is too broad. This section also cleans up ORS 118.013(3)(d) to clarify that an executor attaches a statement of election to the estate tax return and does not attach an election. This parallels with language in ORS 118.016(1)(a) as well.

Section 5: Throughout this section the bill replaces the term "beneficiary" and instead applies the new term, "permissible distribute," from Section 4. The section also deletes the use of the word "distribution" in ORS 118.016(2)(a) so as to cover all possible property interests that may qualify for the Oregon special marital property election and not just trusts. Lastly, this section revises ORS 118.016(4), so as to allow expand the persons who may consent for a permissible distribute who is a minor. The goal of allowing "any person who is authorized under ORS 130.110" to sign, was to also allow noncustodial parents to sign the election if there is no conflict of interest and no conservator has been appointed.

Section 6: This section improves existing ORS 118.100 by providing for a clear and accurate state estate tax due date for payment and filing of the return in (1). The due date is the date the federal estate tax is payable and if no federal estate tax is required, the due date is nine months after the date of the decedent. This rule is the rule in practice today, but the existing statute is inaccurate. This section also revises the refund provision so that the State is not inappropriately paying interest. See policy discussion under Interest Issues above for more detail. The section also makes conforming amendments to replace "inheritance" with "estate" and delete references to the state death tax credit. Other non-substantive form and style edits are also made to the section. Lastly, a new (6) is added to this section. The provision requires that an executor explain, on the return, how the reported values for the property were determined and attach copies of any appraisals.

---

[68] See revisions to ORS 118.010. Note that existing (4)(b) is repealed and existing (3) and (4)(a) are revised so as to tax only resident decedents on their intangibles.

[69] See ORS Chapter 130.

Section 7: This section substantially revises the natural resource credit provision of existing law. The substantive policy changes are explained above in Section VI under the "Natural Resource Property" heading. The bill deletes existing subsections (1) and (2) of ORS 118.140. A walk through of the new (1) and (2) follows:

(1)(a): This subsection provides a definition of "family member," that is then used throughout the Section. The definition is tied to 26 U.S.C. 2032A, as is present law.[70] It is intended to cover "domestic partners" because under ORS 106.340, all privileges, rights, benefits, and responsibilities granted by Oregon law because an individual is or was married or because the individual is or was an in-law is granted on equivalent terms to an individual who is or was in a domestic partnership or is or was, based on a domestic partnership, related in a specified way.

(1)(b): This subsection provides a definition for "farm business." It is a new definition that is used throughout the section and is based on the activities in ORS 308A.056, Washington's farm deduction statute,[71] and the federal farm deduction statute.[72] Present law needed some revisions to better capture the intent of the natural resource credit. Much of the list in this definition came from the "farm use" definition in ORS 308A.056, but that definition could not be just cross-referenced because that definition is a real property definition and the need was to cover both real and personal property properly. Thus, the bill had to list out these items in a new definition. Some additions from "farm use" were made to avoid unintended consequences. For example, "fruit" was added because sometimes "crop" is not always interpreted to include fruit from trees. "Nursery stock" is added in the bill as some nursery products are not "trees." Oregon's present statute uses the word "including" before providing the list of tangible and intangible personal property. Thus the legislature seems to have intended to provide a non-exhaustive list of property eligible for the credit. This bill makes this clearer by providing a true catch-all under the "farm business" definition under (1)(b)(H).

(1)(c): This is the definition of "farm use." Like existing law under ORS 118.140(1)(a), the definition cross-references ORS 308A.056. This definition is used for the real property portion of the natural resource property definition later in (1)(h)(A).

---

[70] See existing ORS 118.140(3)(c). 26 U.S.C. 2032A(e)(2) provides that:

"The term "member of the family" means, with respect to any individual, only—
(A) an ancestor of such individual,
(B) the spouse of such individual,
(C) a lineal descendant of such individual, of such individual's spouse, or of a parent of such individual, or
(D) the spouse of any lineal descendant described in subparagraph (C).

For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as the child of such individual by blood."

[71] Revised Code of Washington 83.100.046(10) (defining farm and farming purposes).

[72] 26 U.S.C. 2032A(e) (defining farm and farming purposes).

(1)(d): This is the definition for the new term "fishing business." It references the federal fishing business definition [73] as present law does.[74]

(1)(e): This definition of "forestland" cross-references ORS 321.201 as present law does.[75] This definition is used for the real property portion of the natural resource property definition later in (1)(h)(A).

(1)(f): This is the new definition of "forestry business." It is a definition that is used throughout the section and is based on definitions in the comparable Washington statute[76] and the federal statute.[77]

(1)(g): This is the definition of "homesite" that tracks with the existing definition that also refers to ORS 308A.250.[78] This definition is used for the real property portion of the natural resource property definition later in (1)(h)(A).

(1)(h): This paragraph provides for a revised definition of "natural resource property." As explained above in the policy section, rather than define natural resource property as only real property but then elsewhere provide that the credit also applies to personal property (and not just real property), this bill lists all the real property and personal property that may be eligible for the natural resource credit as part of the "natural resource property" definition. This revision allows eligible fishing property and an operating allowance also to be covered under the definition of natural resource property. The revision of the definition makes subsequent provisions clearer and allows for essential references to the "natural resource property" throughout the chapter. Subparagraphs (A) through (J) in paragraph (1)(h) are largely self-explanatory and generally track with existing law found at ORS 118.140(2)(a)(C)(i) to (iii) and ORS 118.140(2)(a)(B)(i), (ii). The subparagraphs do expound a bit to track with the new definitions for farm and forestry business. Of note are subparagraph (I) which includes "operating allowance" in the definition of "natural resource property;" as explained, that term replaces the "working capital" concept from present law. Lastly, subparagraph (J) is a catch-all provision that includes any unlisted tangible and intangible property that is used in the operation of a farm, forestry, or fishing business.

(1)(i): This paragraph defines "operating allowance." See "Working Capital Changed to Operating Allowance" discussion above for details on this policy change.

---

[73] 26 U.S.C. 1301(b)(4)(providing that the term "'fishing business' means the conduct of commercial fishing as defined in section 3 of the Magnuson-Stevens Fishery Conservation and Management Act").

[74] See existing ORS 118.140(2)(a)(B)(i).

[75] See existing ORS 118.140(1)(b).

[76] See Revised Code of Washington 83.100.046(10) (defining farming purpose and timber operations).

[77] See 26 U.S.C. 2032A(e) (5)(c).

[78] See existing ORS 118.140(1)(b).

(1)(j): This paragraph provides for the new term, "qualified beneficiary." The definition references that defined term in Oregon's Uniform Trust Code. That term more accurately defines the eligible trust property provided for in (4).

(1)(k): This paragraph defines "real property" and it is largely identical to present law as both reference ORS 307.010. [79] This revised definition clarifies that the real property must be located in Oregon.

(2)(a): This paragraph provides the substantive law provision that an estate is allowed a credit for the value of natural resource property claimed. It goes on to limit the operating allowance that may be claimed as part of the natural resource property. The bill provides a limit on the operating allowance of the lesser of $1.5 million or 20 percent of the total value of the natural resource property claimed, not including the operating allowance. For example, an estate that claimed $5 million in natural resource property, not including operating allowance, could claim up to an additional $1 million in cash and cash equivalents if that money were on hand. The money would need to be used in the farm, forestry, or fishing business for five years. See "Working Capital Changed to Operating Allowance" discussion above for details on this change.

(2)(b): This paragraph provides a formula for calculating the natural resource credit. This formula replaces the schedule in existing ORS 118.140(2)(c). The formula gives a credit based on the percentage of the adjusted gross estate that is claimed natural resource property. The provision caps the natural resource property that may be claimed at $6 million. This new formula focuses on the ratio of natural resource property compared to the adjusted gross estate rather than focusing solely on the amount of natural resource property claimed.

(2)(c): This paragraph and the subparagraphs within it make it clear that while an executor may make a natural resource property election and claim a credit for such property, the executor may choose not to claim a credit at all, may claim less than the full amount allowed, and may pick and choose which assets to claim. This language is akin to existing law.[80]

(3): This subsection and its four paragraphs provide key qualifications for claiming a natural resource property credit. The qualifications include: a) the adjusted gross estate may not exceed $15 million; b) the total value of property meeting the definition of natural resource property must be at least 50% of the total estate (note that the executor need not claim all of the property,

---

[79] ORS 307.010 provides in relevant part:
"'Real property' includes:
(A) The land itself, above or under water;
(B) All buildings, structures, improvements, machinery, equipment or fixtures erected upon, above or affixed to the land;
(C) All mines, minerals, quarries and trees in, under or upon the land;
(D) All water rights and water powers and all other rights and privileges in any way appertaining to the land; or
(E) Any estate, right, title or interest whatever in the land or real property, less than the fee simple."

[80] See existing ORS 118.140(2)(b).

but to qualify for the credit at least 50% must be eligible for a claim); c) the natural resource property must be transferred to a "family member"; and d) the property for which the credit is claimed must be part of a farm, forestry, or fishing business that the decedent or a family member operated for five out of the eight years prior to the decedent's death (look-back requirement). This section was revised to use the new definitions and the look-back was substantively revised here to provide a business look-back requirement. New subsection (5) provides for a real property look-back requirement. See discussion above under "Look Back Requirements" and description of subsection (5) below for further explanation.

(4): This subsection provides three exceptions to the requirements for the credit. Paragraph (a) provides that net cash leases can qualify. That paragraph picks up the new "qualified beneficiary" term from (1)(j), but otherwise tracks existing law. Paragraph (b) provides that trusts can qualify for the credit and also utilizes the new "qualified beneficiary" term; this paragraph also tracks existing law. Lastly, paragraph (c) provides a new exception. It addresses the situation where property is in the process of sale or property is otherwise replaced after the decedent's death but before the estate tax return is filed. The bill provides that property can be replaced in this window and still qualify for the natural resource credit if the replacement property meets the definition of natural resource property as well. In addition, real property may only be replaced with real property to qualify. See discussion above under "Replacement Property" for further explanation.

(5): This subsection provides for a real property look-back requirement. Real property must be owned by the decedent or a family member during an aggregate period of five out of the eight years prior to the decedent's death. Note that a look-back will no longer apply to personal property or operating allowance. See discussion above under the "Look Back Requirements" heading.

(6): This subsection provides for a five out of eight year fishing business look-back requirement. See discussion above under the "Fishing Business Qualifications" heading.

(7): This subsection allows for limited tacking to meet the qualifications for the real property look –back requirement under subsection (5). See policy discussion above under "Look Back Requirement."

(8): This subsection provides that indirect ownership (e.g. ownership in a LLC, corporation, partnership or trust) of property that otherwise meets the requirements of the section may qualify for the natural resource property credit if at least one family member materially participates in the business after the transfer to a family member. The bill makes some nonsubstantive changes to this subsection that utilizes the bill's new definitions, but the subsection is not materially changed.

(9)(a): This paragraph rewrites the beginning of existing paragraph (7)(a) and provides for rules on what will constitute a disposition and additional tax. If property claimed for the natural resource credit is not used in the operation of the farm, forestry, or fishing business or the

property is transferred before the five year requirement is met, there is a disposition. See policy discussion above under "Accountability and Disposition Clarity" heading.

(9)(b): This paragraph codifies OAR 150-118.140(5)(b). The section provides that using claimed natural resource property (cash or other assets) to pay federal or state estate taxes will cause a dispostion. This is consistent with the policy that claimed property must be used for the farm, forestry, or fishing business to avoid a disposition and additional tax.

(9)(c): This paragraph provides that there is not a disposition requiring additional tax when property claimed for the natural resource credit is later conveyed as a qualified conservation contribution under the Internal Revenue Code. This provision is consistent with existing law in paragraph (7)(a).

(9)(d): This paragraph provides that claimed natural resource property may be replaced and replacement will not cause a disposition as long as the replacement property would also qualify as natural resource property. In addition, the bill provides that real property may only be replaced with real property to avoid causing a disposition. The bill provides that replacement must be made within one year, except that property that is involuntarily converted must be replaced within two years. See discussion above under the "Replacement Property" section. Note that subsection (6) of existing law had also allowed replacement when there was an involuntary conversion.

(9)(e): This paragraph provides the formula for computing the additional tax that is imposed when there is a disposition or disqualifying event of claimed natural resource property. The provision has been rewritten to use the new ratio formula from paragraph (2)(b). In addition, the statute provides a due date for the additional tax—6 months after the date on which the disposition or disqualifying event occurs.

(9)(f): This paragraph is unchanged. The paragraph simply requires the executor to notify transferees of claimed natural resource property of the potential tax consequences if they fail to meet the continuing requirements of the natural resource credit. The transferee's written acknowledgement of the notice is required.

(10) This subsection provides new requirements to help ensure accountability and enforceability of the natural resource property credit. First, this subsection provides that executors must identify property for which the credit is claimed by asset on a form that is filed with the department. Second, the subsection requires transferees that receive property for which a credit is claimed to file an annual report tracking each asset. See discussion above under "Accountability and Disposition Clarity" heading for further explanation.

Section 8: This section increases the Oregon threshold from $1 million to $1.5 million. The Oregon threshold has not been increased for five years. ORS 118.160(2) is also amended in this section to delete vestiges from the long repealed state gift tax. Other form and style edits are made as are replacements of the word "inheritance" to "estate" where appropriate.

Section 9: This section changes "inheritance" to "estate" where appropriate.

Section 10: This is the section that allows an executor to get an extension of time to pay the estate tax upon application and the securing of collateral. The section has one conforming amendment which replaces the cross-reference of ORS 118.220 with ORS 118.100 as the former is repealed under the bill.

Section 11: This section is the main penalties and interest provision for the estate tax chapter. This section has been revised to eliminate the enhanced (tier 2) interest penalties provided by ORS 305.222 when the estate has been granted an extension under ORS 118.225 or given a bond under ORS 118.300. In addition, the section provides that the State of Oregon will no longer pay interest on refunds in certain cases. See policy discussion regarding these issues above under "Interest Issues" heading. The section also references ORS 118.100 instead of ORS 118.220 as the substance of the latter has been folded into ORS 118.100 and ORS 118.220 is repealed under the bill.

Section 12: This section changes "inheritance" to "estate" where appropriate.

Section 13: This section makes a couple of non-substantive changes. It uses the term "beneficiary" as that is a defined term in Section 1. In addition, it replaces ORS 118.220 with ORS 118.100 as the bill repeals ORS 118.220 and the substance of that provision will now be in ORS 118.100.

Section 14 and Section 15: These two sections simply make conforming amendments that are not substantive. The main change is to change "inheritance" to "estate" where appropriate. In addition, Legislative Counsel form and style wording changes are made in these sections.

Section 16: This section updates the tie-in date to the federal Internal Revenue Code for tax qualified disclaimers by changing the effective date from January 1, 2002 to December 31, 2010. This provision is one section of the ORS 105.623 to 105.649 series, which is Oregon's version of the Uniform Disclaimer of Property Interests Act; the series was enacted in 2001. The purpose of this series is to allow beneficiaries of intestate, testamentary and nontestamentary (nonprobate) interests to execute a disclaimer of those interests. A disclaimer extinguishes the interest as if that interest had never been granted. Disclaimers are used to reallocate interests in estates, trusts and other kinds of property holdings in which benefits may be allocated at death. This amendment is needed in order to accommodate the disclaimer extension provided under Congress' recent H.R. 4853, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Section 301(d). The 2010 Act makes the estate tax effective retroactively for estates of decedents dying after 2009, while allowing the opt-out choice for estates of decedents dying during the 2010 tax year. As a result, § 301 of the 2010 Act provides an extension of the period in which an individual can disclaim an inheritance. Oregon needs to revise its connection date to allow the same extension and this section does that by connecting to a date after this new federal law. The uniform act uses no federal connection date, but Oregon must choose a date due to Oregon's state constitutional requirements. See Or. Const. art. I, § 21 and *Seale v. McKennon*, 215 Or. 562, 572 (1959). This connection date should be reviewed

more often (i.e. in each future legislative session), similar to the income tax law connection date, to be sure Oregon has an appropriate federal tie-in date.

Section 17 to Section 24: These sections simply make conforming amendments that are not substantive. The main change is to change "inheritance" to "estate" where appropriate. In addition, Legislative Counsel form and style wording changes are made in these sections.

Section 25: This section makes a modification to the provision regarding interest on refunds that is consistent with the changes made to ORS 118.260(7).

Section 26: This section simply makes new sections 27 to 29 part of ORS Chapter 118, the estate tax chapter.

Section 27: When there is a dispute regarding the domicile of a decedent, this section empowers the Department of Revenue to negotiate with the tax authorities of another claimant state, with the consent of the executor or administrator, and to compromise the amount of the estate tax. Under such an agreement each claimant state would likely receive something, although less than the full amount of its claim and the estate avoids double taxation and litigation. The section replaces the outdated uniform act series of ORS 118.855 to ORS 118.880 that is repealed by the bill in Section 31. The section also allows the Department of Revenue to enter into binding arbitration or a compromise agreement with respect to disputed liability for estate taxes with each taxing official and with the executor.

Section 28: This section codifies statute of limitation provisions for the estate tax in the estate tax chapter, ORS Chapter 118. The section is based on ORS 314.410(1), (2), and (3)(a). Present law does not provide a clear statute of limitations for estate taxes and thus this is a new section of law. See above discussion under "Department of Revenue" heading for more analysis of this policy decision.

Section 29: This is the section of the bill that addresses estates of decedents who die after January 1, 2011, but before the bill takes effect. The section provides these estates with extra time to file the return. That is, the return will not be due until the later of nine months after death or two months after the effective date of the Act. However, the estate tax will still be due and payable nine months after death so as not to effect the State's revenue stream. In other words, the law gives executors more time to finish up the paperwork of the return and apply the new law, but the tax money is still due under the old law. If the tax increases due to this bill, the executor is required to file an amended return accompanied by the payment of the additional tax. If there is a decrease in the taxes, due to the retroactive treatment of this bill, the executor may file an amended return claiming a refund. Interest and penalties assessed due to the retroactive treatment of the new law will also be delayed 60 days.

Section 30: This is the repealer section of the bill. ORS 118.009 is repealed because the legislative findings from 2003 are outdated as the findings were written in response to the repeal of the state death tax credit on the federal return. ORS 118.019 is repealed because the substance of that provision, regarding Oregon special marital property, has been folded into the revised

ORS 118.010. ORS 118.220 is repealed because it is inaccurate and because the due date for estate taxes is provided by revised ORS 118.100(1) of the bill. ORS 118.240 is repealed because it is a vestige of the old gift tax that was repealed in Oregon in 1997, and it is no longer needed. ORS 118.470 is repealed because the statute is from the old probate and certificate system that no longer exists. The bill repeals the ORS 118.810 to ORS 118.840 series because these statutes are from a uniform act that is outdated and no longer in use. In addition, the bill repeals the ORS 118.855 to 118.880 series as that uniform act is also outdated and is more complex than it needs to be. The act was intended to address the situation where more than one state claims to be the decedent's domicile. The substance of the act has been rewritten and shortened; it can be found in new Section 27 of the bill.

Section 31: This section provides that the bill applies to estates of decedents who die on or after January 1, 2011. Thus, the bill is retroactive for some decedents. However, estate taxes are not due until nine months after the decedent's death and thus, if the bill is passed early in 2011, estates will be on notice of the new law and the transition should be smooth.

Section 32: This section provides the effective date of the bill. It is the earliest date it can be effective, i.e. 90 days after sine die, as provided by Article IV, Section 28 and Article IX, Section 1a of the Oregon Constitution.

IX. Conclusion

This bill is the result of approximately 18 months of work by dedicated volunteers with great experience in the area of estate tax law and policy. The bill substantially rewrites ORS Chapter 118 to improve, modernize, correct and clarify the state estate tax law. Many technical and policy changes are made in the chapter with this bill, and this report strives to explain them. The Oregon Law Commission's Inheritance Tax Work Group believes these changes provide a significant improvement upon the present law.

Respectfully submitted,

Wendy J. Johnson[81]
Deputy Director and General Counsel, Oregon Law Commission
Staff to Inheritance Tax Work Group

[81] A word of thanks: This was truly a wonderful Work Group to work with, and I extend my thanks to all. In addition to the countless hours provided by the Work Group, I would especially like to thank Lane Shetterly, Kate Tosswill, Jeff Cheyne, Debra Buchanan, Mazen Malik, and Jeff Dobbins for their extraordinary assistance in completing this Commission project. Without their devotion, patience, and expertise, this project could not have been completed so successfully.