

2008 Special Legislative Session Establishes Farming, Forestry, and Fishing Inheritance Tax Credit

Near the end of the 2007 legislative session, the Oregon legislature passed HB 3201 with the understanding that it would provide a \$7.5 million Inheritance Tax exemption for forests, farms and commercial fishing operations. HB 3201 §68, ORS 118.140. After the bill passed, the Oregon Department of Revenue (“ODR”) was informally advised by the attorney general’s office that the “natural resources” definition in HB 3201 only applied to land; thus excluding trees and timber. Farmland was included, but it was unclear whether or not farm buildings, crops, and equipment were included. There was doubt as to whether qualified property that was held in a limited liability company, corporation, partnership or trust would qualify under HB 3201. In addition to these questions, there were a number of other unresolved issues, including which provisions of section 2032A of the Internal Revenue Code applied to HB 3201.

After the 2007 session, Representative Phil Barnhart, Chair of the House Revenue Committee; Senator Ginny Burdick, Chair of the Senate Revenue and Finance Committee; and Paul Warner, Legislative Revenue Officer considered the need for corrective legislation. Then Mr. Warner requested input from a group of attorneys and accountants who were organized with the help of the Oregon State Bar staff to formulate the policy issues that the legislature needed to resolve. Members of the workgroup participated in several hearings with the Senate Finance and Revenue Committee and the House Revenue Committee. Representative Barnhart as chair of the House Revenue Committee undertook the corrective legislation project, and HB 3618 was approved for introduction to the 2008 special session.

The policy goal of the legislation was to help preserve natural resource property and commercial fishing property that would otherwise have to be partially liquidated to pay the Oregon Inheritance taxes. For example, consider a decedent who owned 50 acres of forestland with trees that had grown to half of their maturity level. If the trees had to be harvested prematurely to pay the Oregon Inheritance tax, more trees would have to be cut because they would only be worth a small fraction of their worth at maturity. This bill was supported by nurseries, farmers, commercial fishing operators and winery owners, and it passed in both the House and the Senate with bipartisan support. However, the new legislation left out a number of small woodlot

owners, and some legislators indicated that this issue would be revisited in 2009. HB 3618 left a number of issues remaining, such as inflation adjustments and some further technical corrections that the legislators plan to address in the 2009 session.

HB 3618 redefined the farm and forest natural resource property definitions to include all types of farm and forest property as the original authors intended. Property used in farming refers to the property definitions included in ORS 308A.56 and ORS 308A.250, and then includes tangible and intangible personal property, farming equipment, crops (growing and stored), and working capital. HB 3618 §1, ORS 118.140(1)(a) & (2)(a)(C). Forestland natural resource property now includes timber, trees, improvements, working capital, forestry equipment, and land not to exceed 5,000 acres. HB 3618 §1, ORS 118.140(1)(b) & (2)(a)(C). According to legislative testimony, the bill includes ranching enterprises, such as cattle and other livestock as well. Biofuel crops, land and production facilities will be eligible in tax years beginning on or after July 1, 2008. 2007 Statutes Chapter 739 §38, ORS 308A.56.

Definitions are now included for commercial fishing operations. If a decedent had a license under ORS Chapter 508, then the decedent's boat(s), gear, equipment, vessel licenses and permits, commercial fishing licenses and permits, and working capital are included as eligible credit property. Property used to process and sell the catch of the fishing business including a restaurant with less than 15 seats are also included. HB 3618 §1, ORS 118.140(1)(b) & (2)(a)(B).

The authors of HB 3201 intended to exempt up to \$7.5 million of natural resource property, and then the tax exemption would quickly disappear as the taxable estate value increased over \$7.5 million. However, HB 3201 did not achieve this result. Instead of an exemption, HB 3201 created a \$7.5 million natural and fishing resource gross estate exclusion. As a result, HB 3201 had revenue loss implications that had not been fully considered.

HB 3618 replaces the HB 3201 \$7.5 million exclusion with a \$7.5 million credit for eligible farming, forestry and fishing property. First, one calculates the Oregon Inheritance Tax (“OITax”) on the taxable estate. For example, assume the taxable estate has a value of \$10.5

million dollars. The OITax would be \$1,146,800. Assume further that \$6.6 million of the taxable estate is eligible farming property. Based on the credit table contained in the bill, the credit would be \$586,800. HB 3618 §1, ORS 118.140(2)(c). After subtracting the credit, the net OITax would be \$560,000. Because the tax credit is calculated independently from the tax calculation for the taxable estate, it is not a dollar-for-dollar offset. If the value of the credit eligible property exceeds \$7.5 million, the credit gradually reduces to zero when the value of the credit eligible property reaches \$15 million. If the adjusted gross estate exceeds \$15 million, no credit is allowed.

In addition to the foregoing, HB 3618 added several other provisions to reflect actual taxpayer ownership and reduce the opportunities for tax manipulation:

First, the value of the property eligible for the credit must be at least 50 percent of the total adjusted gross estate. HB 3618 §1, ORS 118.140(3)(b). This new 50 percent requirement excludes a number of woodlot owners, farmers, and fishing owners who fail to meet this test.

Second, the property must be transferred to a “member of the family,” as defined in IRC 2032A, or to a registered domestic partner of the decedent. HB 3618 §1, ORS 118.140(3)(c) and IRC 2032A(e)(2). HB 3618 does not apply to deceased domestic partners unless he or she has become a registered domestic partner under Oregon law.

Third, during five out of the last eight years prior to the decedent’s death, the decedent, or a member of the decedent’s family must have used the credit eligible property for farm or forest purposes. HB 3618 §1, ORS 118.140(3)(d). This “look-back” requirement was not in the former law. Fishing businesses were inadvertently left out of this requirement. It is expected that ODR will adopt regulations exempting fishing operations from the “look-back” restriction.

In addition to the “look-back” restriction, HB 3618 also continues the “look-forward” restriction which limits a transferee’s disposition and use of the property. If a transferee disposes of credit eligible property or ceases to use credit eligible property at any time prior to the running of five out of eight calendar years following the decedent’s death, an additional tax will be due based on

the portion of credit eligible property which is disqualified. The tax is then prorated based on the number of years remaining in the five year use period. The tax is the responsibility of the transferee selling or otherwise causing the property to no longer be credit eligible. HB 3618 §1, ORS 118.140(7)(a) & (b). If credit eligible property is disposed of through condemnation and then replaced with credit eligible property, or a conservation easement is created, the property will not be disqualified. HB 3618 §1, ORS 118.140(6) & (7)(a).

Fourth, eligible property held in entities such as corporations, partnerships, limited liability companies and trusts will qualify for the credit, provided that at least one of the transferees must materially participate, which is based on an active management standard as defined in IRC 2032A. HB 3618 §1, ORS 118.140(5). Eligible property subject to a net cash lease also qualifies. HB 3618 §1, ORS 118.140(4)(a). It is anticipated that ODR will adopt regulations regarding entities, material participation and active management.

Fifth, prior to the transfer, the executor must notify the transferee of the potential tax consequences. The transferee must acknowledge this notice in writing, and that writing must be attached to the return filed with ODR. HB 3618 §1, ORS 118.140(7)(c). It is comforting to note that the new bill relieved the decedent of this responsibility.

The representative of the estate has several options in connection with the use of the credit: full, partial, or no credit elections can be made, and the credit can be applied to specific assets. HB 3618 §1, ORS 118.140(2)(b).

HB 3618 will be effective on May 23, 2008. It will be retroactive to January 1, 2007, except for domestic partners and bio-fuel property. ODR has informally indicated that temporary regulations will be adopted on or shortly after the effective date with permanent regulations to be adopted within six months after that. ODR must cancel any interest or penalties due prior to May 23, 2008. For any deaths prior to the May 23, 2008, no taxes will be due until after June 30, 2008. HB 3618 §2.

Estate planning for this new credit will require additional analysis. Care must be taken to insure that the 50 percent requirement is maintained with each individual owning credit eligible property. Transfers to family members will be fairly straightforward provided the transfers are dispositions of credit eligible property at death, or transfers of cash leases. Gifts of credit eligible property or sales of credit eligible property will have to be more closely scrutinized, because such dispositions could drop a taxpayer below the 50 percent requirement.

For married couples holding credit eligible property, ODR will have to clarify in its rule making process whether or not a decedent can make a QTIP or marital deduction election for federal tax purposes and make a credit election, rather than a marital deduction election for Oregon tax purposes.

Estate planning with entities holding credit eligible properties will be considerably more complex, especially when the federal estate tax exemption, the generation skipping tax exemption, the Oregon qualified property credit, and the marital deduction (if the decedent was married) need to be coordinated.

HB 3618 answers a number of questions that resulted from HB 3201. But as with most new legislation, more questions will develop as these new provisions are applied to real life situations. Clients who are farmers, ranchers, forestry lot owners, nursery owners, winery owners, fruit growers, bio-fuel producers and commercial fishing operators should have their estate plans reviewed to determine whether or not further changes are necessary to accommodate this new law.

The workgroup of attorneys and accountants appreciated the opportunity to act as a tax advisory resource to the legislature. Representative Barnhart and Senator Burdick deserve a special thanks for diligently leading this corrective legislation through the special session.

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