



## OREGON INHERITANCE TAX CHANGES – (HB 3072)

**Special Note:** *If you represent a decedent who died during the first six months of 2003 with a gross estate value of less than \$1 million and a taxable value of more than \$700,000 and have not filed an Oregon Inheritance tax return, you may be facing a shortened filing deadline. If the estate fails to pay the Oregon inheritance tax by the filing deadline, the estate could incur filing penalties of 5% to 20% depending upon the time delay in filing. If you have a shortened deadline, contact the Oregon Department of Revenue in writing to request an extension.*

After five special sessions and two regular sessions, the Oregon Legislature has finally enacted long-awaited changes to the Oregon Inheritance Tax law. In general, the new law ratifies the administrative procedures that the Oregon Department of Revenue followed during tax years 1998 through 2001. For 2003 and future years, the Oregon Inheritance Tax law will follow the exemptions provided in the Taxpayer Relief Act of 1997. However, reexamine 2002 decedent estates to determine whether there is a basis for a refund or, in some cases, if taxes are due.

Beginning in 2002 Oregon’s inheritance tax exemptions no longer parallel the federal exemptions as illustrated by the following table:

### Oregon/Federal Exemption Disconnect

Tax Year	Oregon Exemption	Federal Exemption
2002	\$999,999	\$1,000,000
2003	\$700,000	\$1,000,000
2004	\$850,000	\$1,500,000
2005	\$950,000	\$1,500,000
2006	\$1,000,000	\$2,000,000
2007	\$1,000,000	\$2,000,000
2008	\$1,000,000	\$2,000,000
2009	\$1,000,000	\$3,500,000
2010	\$1,000,000	REPEALED
2011	\$1,000,000	\$1,000,000

**Effective Date and Legislative Background.** In the final days of the 72nd Oregon legislative session the House and the Senate were each considering different inheritance tax bills. Utilizing the “gut and stuff” procedure to expedite processing, the House was in the process of amending SB 362 and the Senate had amended HB 3072. Passage of SB 362 was delayed in the House, because it was necessary to print a minority report. On August 26, 2003, the Senate passed HB 3072, referred it back to the

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House, and then adjourned. On August 27, 2003, HB 3072 was back before the House for a concurrence vote.

Time had run out. The representatives in the House had the choice of either approving HB 3072, which provided some, but not all, of the changes they were looking for, or having no inheritance tax legislation at all. On August 27, 2003, the House passed HB 3072. The governor signed the bill on September 24, 2003. It will become effective on November 26, 2003.

A copy of HB 3072 can be obtained at <http://www.leg.state.or.us/03reg/asures/hb3000.dir/hb3072.en.html>. Also, a copy of the latest Inheritance Tax Advisory from the Oregon Department of Revenue can be obtained at <http://www.dor.state.or.us/taxInfo/Inhtaxadv.html>.

#### ***Inheritance Tax Tied to IRC as of 12/31/2000.***

For estates after January 1, 1998, HB 3072 generally ties the Oregon Inheritance Tax (“OTax”) law to the Internal Revenue Code as it existed on December 31, 2000. See Sections 2 and 3 of HB 3072. As a result, Oregon has adopted the federal exemptions established in the Taxpayer Relief Act of 1997 (“TRA 97”), that provides for incremental increases in the Oregon inheritance tax exemption, which in 2003 is \$700,000, and then gradually increases to \$1 million in 2006. The current federal estate tax exemption of \$1 million, the scheduled exemption increases, and the other changes enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) were not adopted. For example, the federal exemption for 2003 is \$1 million, but the OTax exemption will only be \$700,000. For 2004 the federal exemption will increase to \$1,500,000, but the OTax exemption will increase to \$850,000. See Section 7 of HB 3072.

#### ***1998 through 2001 Inheritance Tax Changes.***

For tax years 1998 through 2001, the existing Oregon Department of Revenue (“ODR”) policies remain the same. HB 3072 ratified the administrative practices that the ODR had been following. In other words, if an estate was not required to file a federal estate tax return under TRA 97, no OTax is due. If an estate was required to file a federal estate tax return, the OTax generally equaled the amount allowed as a state death tax credit under Section 2011 of the Internal Revenue Code. If a taxpayer has filed an OTax return in accordance with the ODR instructions and paid the tax, no additional tax is due. For example, no

OTax was due for the 2001 tax year unless the taxable estate value exceeded \$675,000. If the gross estate value exceeded \$675,000, a federal estate tax return was required (ORS 118.160), and if the taxable estate exceeded \$675,000, an OTax was due (ORS 118.010).

***2002 Inheritance Tax Changes.*** Oregon’s “disconnect” from the federal exemption and state death tax credit structure begins with 2002 decedent estates. It is important to review Section 10 of HB 3072 because it isolates 2002 estates from the other changes. Subsection (1) of Section 10 states that a return for a 2002 estate “is not required and no tax is due... if the **taxable** estate of the decedent is less than \$1 million.” Subsection (2) of Section 10 confusingly provides “(i)f a tax return is required under subsection (1) of this section...,” the OTax “shall be determined under the Internal Revenue Code as amended and in effect on December 31, 2000, using a unified credit that does not exceed \$192,800.” In other words, if the 2002 decedent’s estate has a **taxable** value of \$1 million or more, the OTax is calculated on the basis of the \$600,000 exemption equivalent.

2002 estates can be grouped into four categories: (1) estates with a taxable value in excess of \$1 million, (2) estates with a taxable value of \$600,000 or less, (3) estates with a taxable value less than \$1 million but greater than \$600,000, and (4) estates with a taxable value of exactly \$1 million.

***2002 Estates Over \$1 Million.*** Estates with a taxable value in excess of \$1 million are not affected by the new law and will owe OTax based on an amount equal to 100% of the state death tax credit calculated on the basis of a \$600,000 exemption credit. For estates in this category, the OTax will generally be in excess of \$33,200, unless the tax is reduced due to apportionment with another state. In addition, Oregon will not follow the 25% federal reduction in the state death tax credit for 2002 estates that was adopted in EGTRRA.

***2002 Estates of \$600,000 or Less.*** Estates in the second category are those estates with a taxable value of less than \$600,000. These estates are not affected by the new law and no OTax is due. An ODR representative indicated that they were beginning to process 2002 returns in the first two categories because they were not changed by the new law.

***2002 Estates With Less Than \$1 Million of Taxable Value.*** In the third category are those es-

tates with a taxable value of less than \$1 million. As a result of the wording of subsection (1) of Section 10 of HB 3072, these estates owe no OTax. ODR did not intend for this result to happen, but it will follow the law change. Any estate in this category that has already paid its OTax will be entitled to a full refund. Because of staffing limitations, ODR is expected to announce that it will automatically process refunds for these returns without the necessity of requiring an amended return to claim the refund. ODR will begin processing returns in this category after November 26, 2003, when the new law becomes effective. Please check the ODR website for the latest information on estates in this category.

**2002 Estates of \$1 Million of Taxable Value.** 2002 estates with a taxable value of exactly \$1 million are the problem area. Subsection (1) of Section 10 only eliminates the OTax for **taxable** estates of **less than \$1 million**. Because of the words “less than \$1 million,” 2002 estates with a taxable value of exactly \$1 million will have an OTax liability of \$33,200, even though no federal estate tax is due. As a result, many surviving spouses with estate plans that utilized a credit shelter exemption trust based on a federal exemption formula will still be subject to an OTax of up to \$33,200. This is because the credit shelter or marital deduction funding formula causes the taxable estate to automatically adjust to exactly \$1 million.

Attorneys with estates in this category should reexamine them to determine if there are any additional deductions that can be utilized to reduce the taxable estate to less than \$1 million. This will not be easy for estates in which the taxable value is determined on the basis of a federal exemption funding formula. In many formula situations the effect of increasing additional deductions will only cause the formula to decrease the marital deduction. As a result, the taxable estate of \$1 million will remain the same. It may be possible to make a state QTIP election for 2002 estates. If deductions can be found that are not offset by a formula adjustment, the estate should consider amending the OTax return and claiming a full refund of any OTax that had been previously deposited with ODR.

Attorneys may have to turn to the courts to seek reformation of their clients' trusts so that the OTax can be deferred until the second spouse dies. However, until ODR issues its rules in this area, reformation actions are probably premature. In light of the

questions in this area, one should consider seeking an extension from ODR so that the right to take any remedial actions can be preserved. Periodically, check with the ODR inheritance tax advisory website to determine if there is any relief for taxable estates with a value of exactly \$1 million.

**2003 Inheritance Tax Changes.** For 2003 estates and the years following, HB 3072 will require additional work for attorneys and CPAs both for pre-death planning and post-mortem planning. In 2003, a Form 706 estate tax return must be prepared and filed for every estate with a **gross** value over \$700,000. Please note that this requirement is a conceptual shift from 2002 estates. The 2002 estate tax provisions in Section 10 of HB 3072 are based on a **taxable** estate; whereas, for 2003 and future years, the tax provisions are based on a **gross** estate. See Section 7 of HB 3072.

The Oregon Tax Form IT-1 for 2003 has been released and can be downloaded from the ODR website. For an estate with a gross value between \$700,000 and \$999,999, even though a federal estate tax return is not required for the IRS, a federal Form 706 estate tax return will, nevertheless, have to be completed and filed with Oregon's IT-1 form. ODR is requiring the 706 federal estate tax form in addition to the IT-1 form, since it provides the valuation and deduction details necessary to compute the OTax. No OTax will be due until the taxable estate reaches \$700,000 or more. Therefore, it is possible that an estate may be required to file an OTax return because the estate is over \$700,000, but not be required to pay any OTax because the taxable estate is less than \$700,000.

It should be noted that if an estate has a **gross** value in excess of \$700,000 but a **taxable** value of less than \$700,000, no tax will be due and no penalties will be due if a taxpayer decides not to file a tax return. See ORS 118.260. Even though a taxpayer does not owe any tax, it may still be prudent to file a tax return in order to trigger the three-year statute of limitations. See Section 8 of HB 3072, which amends ORS 118.230 to tie the assessment and collection procedures of the OTax to ORS Chapter 314. The OTax now has a statute of limitations.

Any 2003 Oregon estate with a taxable value in excess of \$700,000 will owe an OTax based on the lesser of the estate tax or the state death tax credit as computed on Oregon Tax Form IT-1 pursuant to the form instructions.

**Issues for Married Couples.** If the first spouse died in 2003, a request for an extension to file should be considered. Subparagraph (7) of Section 6 of HB 3072 authorizes ODR to adopt “rules providing for a separate election for state inheritance tax purposes.” The instructions to the 2003 Tax Form IT-1 state: “A separate election under IRC 2032 or 2056 (such as alternate valuation or the marital deduction) may be claimed for Oregon purposes.”

One of the dilemmas that attorneys face with 2003 married estates is how to handle the \$300,000 difference between the Oregon exemption of \$700,000 and the federal exemption of \$1 million. It appears that it is now possible to make a federal QTIP election that will set aside a taxable estate of \$1 million that is exempt from federal taxes, and also make a state QTIP election that will leave a taxable estate for Oregon purposes of \$700,000 that is exempt from OTax.

However, ODR has not adopted any rules, and according to an ODR representative, is unlikely to do so until 2004. If an estate requires a state QTIP election prior to ODR adopting its rules, either file a return with a separate election for Oregon purposes or contact ODR to discuss an extension of time under Section 9 of HB 3072, which authorizes ODR to “extend the time for the filing of a return and for the payment of any tax... for a reasonable period not to exceed four years from the date otherwise fixed for the filing of a return and the payment of the tax due.”

**2004 Inheritance Tax Changes.** For 2004 estates, the Oregon inheritance tax filing requirement will increase for estates with a gross value of \$850,000 or more. In 2004 the federal exemption increases to \$1,500,000. The difference between the Oregon exemption and the federal exemption will be \$650,000. The OTax for a 2004 taxable estate of \$1,500,000 will be \$64,400.

**2005, 2006, and Future Years Inheritance Tax Changes.** In 2005 the Oregon exemption will increase to \$950,000, and in 2006 the exemption will increase to \$1 million. After 2006, the \$1 million exemption will remain until the inheritance tax law is changed at some point in the future. For all tax years, the OTax will remain at 100% of the state death tax credit, as determined pursuant to IRC Section 2011 as the federal law existed on December 31, 2000.

*Estate Planning Changes Necessary for Mar-*

*ried Couples.* Married couples whose estate plans include credit-shelter trusts based on federal exemption funding formulas face an unexpected OTax when the first spouse dies. For example, if the first spouse dies in 2003 with a taxable estate of \$1 million, and the credit-shelter trust is funded based on the current federal exemption-amount formula of \$1 million, as opposed to the Oregon exemption amount of \$700,000, an OTax of \$33,200 would be due even though no federal estate tax is due. If the first spouse dies in 2004 with a taxable estate of \$1.5 million, and the credit-shelter trust is funded based on the 2004 federal exclusion-amount formula of \$1.5 million, as opposed to the Oregon exemption amount of \$850,000, an OTax of \$64,400 would be due even though no federal estate tax is due.

**Disclosures to Married Clients.** As a result of the passage of HB 3072, practitioners should now consider advising their married clients that there may be unexpected Oregon estate tax ramifications. Because of the difference between the Oregon exemption amounts and the federal exemption amounts, most estate plans for married couples with credit-shelter trust or marital deduction funding formulas should be reviewed and probably revised.

According to the 2003 Form IT-1 instructions, it is now possible to avoid both the federal estate tax and the OTax when the first spouse dies with combined federal and state marital deduction elections. Estate planning documents should be reviewed to determine whether an amendment is appropriate to allow for both a federal QTIP election (so that the federal exemption can be maintained) and a state QTIP election (to utilize the Oregon exemption).

With properly drafted documents, it is possible to preserve both the federal and Oregon exemption so that the surviving spouse can defer paying federal estate tax and OTax until the surviving spouse dies. When ODR issues its rules on this issue, more precise drafting options can be determined. For an example of a trust provision that allows a state QTIP election in a credit shelter trust, see Stephen J. Klarquist, *Funding Formulas for Inheritance Taxes*, Oregon Estate Planning and Administration Section Newsletter No. 4 (October 2003).

For unmarried individuals, these computational issues need to be reviewed so that each client can decide whether to take further steps to reduce the value of his or her estate in order to reduce or, in some cases, avoid the Oregon estate tax.

**Administration Tips.** 2002 estates with a **taxable** value of more than \$1 million should make arrangements to pay any remaining OTax liability and then proceed with the distribution of the balance of the estate. 2002 estates with a **taxable** value of less than \$1 million that did not pay any OTax may now proceed with distribution of the estate, since no OTax is due. 2002 estates with a **taxable** value of less than \$1 million that paid OTax can either request a refund or wait until ODR processes the return and then proceed with closing the estate. 2002 estates with a **taxable** value of exactly \$1 million should be reviewed to determine if there is any basis to reduce the taxable estate to less than \$1 million and thus avoid any OTax.

2003 estates with a **gross** value of \$700,000 or more are subject to the new tax changes. Because of these new changes, it may be necessary to initiate court proceedings to reform the estate planning documents so that the OTax can be avoided on the first spouse's death.

**The Future.** The ODR is beginning to consider the rules for reporting the estate elections that are unique to Oregon and is seeking input from the professional estate planning community. If you are interested in working with ODR and estate planners on these rules, please contact Susan Evans Grabe at the OSB (503-431-6380) or the author.

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