THE NEW OREGON INHERITANCE TAX – A/K/A WHAT'S A LITTLE MORE CHAOS?

I. Background.

Until recently, Oregon's inheritance tax rules were "connected" to the Internal Revenue Code of 1986 (the "Code") as it applied to federal estate and other transfer taxes. Until recently, practitioners could rely upon planning under the federal rules, knowing that any tax consequences in connection with federal tax planning would generally be consistent with the tax consequences occurring under the Oregon inheritance tax ("OTax"). These remained the basic rules forming the foundation for estate and gift tax planning through the year 2000.

A. EGTRRA. The Economic Growth and Tax Relief Reconciliation Act of 2001, commonly referred to as "EGTRRA," included sweeping changes in the estate and gift tax area. Two of these changes resulted in a profound effect upon the amount of tax which would be payable to the state of Oregon for estates of decedents who died after the year 2000. Prior to the passage of EGTRRA, Oregon relied upon the federal estate tax rules embodied in the Taxpayer Relief Act of 1997 (commonly referred to as the "1997 TRA"). Under the 1997 TRA, the federal estate tax applicable exclusion amount under IRC §2010 (the "Federal Exemption") increased to a maximum amount of $1 million in the year 2006 under a gradual transitional rule. For the 2005 calendar year, the Federal Exemption would have been $950,000.

1. 1997 TRA - Oregon and Federal Exemption Equivalents. The pre-EG TRRA phase of the exemptions under 1997 TRRA would have increased as follows:

Tax Year	Amount
2004	$850,000
2005	$950,000
2006 and thereafter	$1 million

2. The State Death Tax Credit under 1997 and EGTRRA. One of the significant benefits derived by the State of Oregon under the 1997 TRA was the state tax revenue generated as a result of the State Death Tax Credit, embodied in IRC §2011. Under this section, which was designed to provide a device for sharing revenues collected by the federal government with the state where taxable property was located, a certain predetermined (depending on the size of the estate) amount of the federal tax would actually be reduced if that amount was paid directly to the state where taxable property was located. The State Death Tax Credit, which was based upon the federal taxable estate less $60,000, provided for the following reductions in federal estate tax:

Column 1 Adjusted taxable estate equal to or more than	Column 2 Adjusted taxable estate less than	Column 3 Tax on amount in column 1	Column 4 Rate of tax on excess over amount in column 1 (percent)
0	$40,000	0	None
$40,000	90,000	0	0.8
90,000	140,000	400	1.6
140,000	240,000	1,200	2.4
240,000	440,000	3,600	3.2
440,000	640,000	10,000	4.0
640,000	840,000	18,000	4.8
840,000	1,040,000	27,600	5.6
1,040,000	1,540,000	38,800	6.4
1,540,000	2,040,000	70,800	7.2
2,040,000	2,540,000	106,800	8.0
2,540,000	3,040,000	146,800	8.8
3,040,000	3,540,000	190,800	9.6
3,540,000	4,040,000	238,800	10.4
4,040,000	5,040,000	290,800	11.2
5,040,000	6,040,000	402,800	12.0
6,040,000	7,040,000	522,800	12.8
7,040,000	8,040,000	650,800	13.6
8,040,000	9,040,000	786,800	14.4
9,040,000	10,040,000	930,800	15.2
10,040,000	-	1,082,800	16.0

The above table provided a direct dollar-for-dollar offset against federal tax if the amount was actually paid to the state where the taxable property was deemed to be located. EGTRRA, however, changed these rules by providing that commencing with deaths in the year 2001, the federal State Death Tax Credit computed in connection with each estate would be reduced. In 2002, the dollar-for-dollar credit for state death taxes was reduced by 25%. That reduction was 50% in 2003 and 75% in 2004. Commencing in 2005, there is no credit for state death taxes. Instead, taxpayers will be allowed a deduction for their state death taxes on their federal estate tax returns. Where state inheritance tax is deductible on the federal estate tax return, a significant federal benefit (ranging to as much as 45% of the state inheritance tax) may be derived. This is only true, however, in situations where the estate is large enough for the federal estate tax to be applicable.

B. HB3072. As we all know, the state of Oregon is suffering historic budget deficits. Significant programs have been cut, and our legislature is evaluating many different alternative methods for generating funds to fuel state government. Because of these demands, our legislature has taken any and all action it can to protect against further drains in state

revenue sources. It is as a result of these political pressures that on August 27, 2003, the Oregon House passed HB 3072 (see Exhibit 1). This legislation was an eleventh hour "power play" by the Oregon Senate, forcing the House to either approve HB 3072 or have no inheritance tax legislation for the ensuing two years. Faced with no other alternative, and recognizing that HB 3072 did not provide a global answer to the inheritance tax problem created by EGTRRA, the House nevertheless passed the Bill, which was signed by the Governor on September 24, 2003.

C. The disconnect. HB 3072, which became effective on November 26, 2003, basically disconnected from EGTRRA, electing instead to operate under the federal rules as they existed on December 31, 2000. In disconnecting from EGTRRA, Oregon remained connected to the 1997 TRA. The fundamental difference resulting from the disconnect is reflected in the amount of the Federal Exemption available to taxpayers under the federal estate tax law as compared to the exemption available under Oregon's inheritance tax law (the "Oregon Exemption"). These differences are reflected in the following schedule:

Year of Death	Federal Exemption	Oregon Exemption
2003	$1,000,000	$700,000
2004	1,500,000	850,000
2005	1,500,000	950,000
2006	2,000,000	1,000,000
2007	2,000,000	1,000,000
2008	2,000,000	1,000,000
2009	3,500,000	1,000,000
2010	Unlimited	1,000,000
2011	1,000,000	1,000,000

II. Some Observations About HB 3072.

A. Meanings. Under section 2 of the Act, any term used in ORS 118.005 to 118.840 will have the same meaning as used in a comparable context under the Code relating to federal estate taxes, unless a different meaning is clearly required or the term is specifically defined in ORS 118.005 to 118.840. (Emphasis added).

B. Rulemaking authority of the ODR. Section 6 (7) of the Act provides that if the federal taxable estate is determined by making an election under section 2032 or 2056 or another provision of the Code, or if a federal estate tax return is not required under the Code, then the Oregon Department of Revenue (the "ODR") has the right to adopt rules providing for a separate election for state inheritance tax purposes. This election will be discussed later in the outline.

C. Filing rules. With respect to the Oregon Inheritance Return ("Form IT-1") for a decedent who dies after the effective date of HB 3072, the following rules apply:

1. **The basic rules.** If a decedent dies after 1/1/87 and before 1/1/03, no Oregon IT-1 was required unless a Federal Estate Tax Return ("Form 706") was required. In addition, for decedents dying during 2002, no IT-1 was required and no tax was due if the taxable estate was less than $1 million. This means, for 2002 decedents, that unless the taxable estate is $1 million or more, an IT-1 was not required. If, however, an IT-1 was required, the tax was based upon the exemption which existed at the time of the decedent's death under the 1997 TRA, which is $700,000. This would result in an OTax of $33,200. It was important, therefore, to find creative ways to reduce the federal gross estate in those marginal cases where the estate was just tipping the $1 million scale.

D. ODR 5/24/04 advisory. On May 24, 2004, Oregon issued an inheritance tax advisory, which is attached as Exhibit 2. This advisory provided the following clarifications:

■ If a decedent filed and paid tax according to the 1998-2001 OTax return instructions, there is no additional inheritance tax due.

■ If a decedent died during 2002, there was no return required and no tax was due if the federal taxable estate was less than $1 million. If the taxable estate was $1 million or more, the unified credit to be used for 2002 was $192,800 (equal to a $600,000 Federal Exemption).

■ For deaths occurring in 2003 only, taxpayers were granted an automatic 6 month extension for both filing and paying from the date the return was due or November 26, 2003, whichever was later. Although penalties could be assessed, interest continued to run. No additional extension was allowed, and interest was assessed beginning the later of November 27, 2003, or 1 day after the due date.

■ The Oregon filing requirements were specifically identified as follows:

- For 2003, a gross estate of $700,000 or more (equal to a unified credit of $229,800).
- For 2004, a gross estate of $850,000 or more (equal to a unified credit of $287,300).
- For 2005, a gross estate of $950,000 or more (equal to a unified credit of $326,300).
- For 2006 and thereafter, a gross estate of $1 million or more (equal to the unified credit of $345,800).

■ The Oregon estate tax was specifically identified as 100% of the available State Death Tax Credit, instead of the reduced amount under EGTRRA.

1. Taxes due are not a foregone conclusion. Note that the filing requirement does not necessarily result in the incidence of tax. In other words, in a "winner take all" estate (everything to the surviving spouse at the first spouse's death), if the gross estate is greater than $950,000, an Oregon IT-1 will still be required, even though there will be neither federal tax nor OTax incurred as a result of the death.

2. 4-year extensions. Because of the tremendous confusion which existed as a result of the passage of HB 3072, section 9 of the Bill provided that with respect to decedents dying on or after January 1, 2002 and before January 1, 2004, the DOR had the right to extend the time for filing the IT-1 and payment of the tax for a reasonable period, not to exceed 4 years from the original filing and payment date.

III. HB 3072 as it Applies to Current and Prospective Oregon Inheritance Taxes.

A. The 2005 Oregon Exemption. Based upon HB3072, the exemption which would have been in effect under 1997 TRA for the year 2005 is $950,000. The 2005 federal exemption is $1,500,000. The OTax on this difference is actually 11.71%. The Oregon exemption of $950,000 equates to a federal estate tax unified credit of $326,300.

1. The GAP. Therefore, decedents with a gross estate of $950,000 or more will be required to file an OTax return in 2005. This threshold will increase to $1 million in 2006 and thereafter. It is important to note that even though an Oregon return will be due for a decedent whose estate is $950,000 or more, there will be no tax due unless the taxable estate exceeds $950,000. In 2005, the Federal Exemption is $1,500,000. The difference, or $550,000, is the amount which will be subject to OTax and will not be subject to federal estate tax (the "GAP"). The 2005 OTax on the GAP is $64,400. Nor will there be any reduction of the federal tax by virtue of the State Death Tax Credit. Since there is no federal tax on this $550,000 amount, there will also be no deduction for state death taxes under the EGTRRA provisions. As a result, this $550,000 amount receives no shelter.

2. The GAP in 2006. In 2006 and thereafter, the Oregon Exemption increases to an equivalent federal unified credit of $345,800, or a Federal Exemption of $1 million. The Federal Exemption in 2006, however, will increase to $2 million, leaving a $1 million GAP between the Federal Exemption and the Oregon Exemption. This results in an OTax of $99,600.

3. Keeping up with the fluctuating Federal Exemption. From that point forward, the Oregon Exemption will continue to be the equivalent of $1 million. Even though the Federal Exemption continues to increase, going to $3.5 million in 2009 and becoming unlimited in 2010, the Oregon Exemption remains constant at $1 million. This is even more troubling in 2010 when the federal estate tax is repealed. It appears an IT-1 must be filed, based upon a Federal Exemption of $1 million. If the federal law does not change before 2011 (which is highly unlikely) then the Oregon Exemption and Federal Exemption will once again conform to each other at $1 million.

B. Form IT-1. For decedents dying in 2005 and thereafter, a separate IT-1 must be filed, even if a 706 is not required. A copy of the Oregon IT-1 form and instructions for 2004 is attached as **Exhibit 3**. Since the return does not have schedules attached, the Department of Revenue has indicated that taxpayers should use the estate tax schedules from Form 706, even if that form is not filed.

IV. Important Points to Note:

A. 2002 filing emphasis on taxable estate. Note that under HB 3072, the law provides that with respect to decedent's dying in 2002, an OTax return is not due if the taxable estate of the decedent is less than $1 million. However, for 2003, that language changed in HB 3072. In 2003, an Oregon return must be filed for every estate with a gross value of over $700,000. This is a shift from the "taxable estate" analysis under the 2002 rules. Following 2003, the "gross" estate analysis prevails under section 7 of HB 3072.

B. What about 2010? It is also interesting to note that the Department of Revenue is requiring a federal estate tax return to be attached. In 2010, when the federal estate tax is essentially repealed, it is likely that no 706 forms will even be available. However, it may behoove the practitioner to retain the old form 706 for years 2010 and thereafter.

C. Why bother filing? Under ORS 118.260, if a 2005 Oregon estate has a gross value in excess of $950,000 but a net taxable estate of less than that amount, even though a return will be due, there will be no penalties or interest for failing to file the return. Penalties and interest are based upon the tax due. The failure to file a return, however, precludes the running of the 3 year statute of limitations under ORS chapter 314.

D. The Cost of the IT-1. It should be pointed out that the other inherent problem with filing an IT-1 for GAP estates is the fact that a return must be filed at all. This is both costly and time consuming (not to mention annoying).

V. Calculating the OTAX or "Nothing is Simple Anymore"!

As a former litigator partner asked during a review of the financial statements at a partnership meeting, "Can we do this without the numbers?" The answer then, as well as now, is, in a word, "No".

A. Oregon "Gross Estate". Under the new legislation, an OTax return for a 2005 death will be due if the gross estate is $950,000 or more. The gross estate is the amount identified as the gross estate under federal law, which does not include adjusted taxable gifts other than those includable in the decedent's gross estate under Code sections 2001 or 2035. The IT-1 return instructions define the gross estate as "the true cash value of all real and personal property, tangible or intangible, as of the date of death, wherever situated."

B. Identification of the "GAP" and calculating the tax. As the federal estate tax exemption and Oregon inheritance tax exemption amounts change over time, the difference between the two exemptions will be referred to in this outline as the "GAP".

OTax will tax unmarried individuals whose estates exceed the Oregon Exemption and can apply to the GAP between married couples without careful planning and/or estate administration. Planning and administering estates for this GAP requires a knowledge of the available elections and drafting alternatives. The following chart illustrates the "GAP" amounts for the years indicated:

Year of Death	Federal Estate Tax Exemption	Oregon Inheritance Tax Exemption	"GAP"
2003	$1,000,000	$700,000	$300,000
2004	1,500,000	850,000	$650,000
2005	1,500,000	950,000	$550,000
2006	2,000,000	1,000,000	$1,000,000
2007	2,000,000	1,000,000	$1,000,000
2008	2,000,000	1,000,000	$1,000,000
2009	3,500,000	1,000,000	$2,500,000
2010	Unlimited	1,000,000	Unlimited
2011	1,000,000	1,000,000	$0

C. The way the tax works. Although the OTax provides for rates from 0.8% to 16.0% (See Table B. from the instructions to the 2004 Form IT-1 attached in Exhibit 3), computation of the OTax actually involves a multiple step process. The OTax is the smaller of the (1) federal estate tax assuming the 2005 Federal Exclusion equaled $950,000 (the applicable exclusion using a $326,300 applicable credit amount for Oregon in 2005) and (2) the OTax based on the Oregon rate schedule. As illustrated by the example below, one cannot simply estimate the OTax using the Oregon tax rates; the most accurate method for calculating the OTax involves completing the form IT-1 for the year of death.

1. Step 1 – Calculate Tentative Federal Tax. The unified federal estate and gift tax rates effective under federal law as of December 31, 2000 are applied to the total lifetime and death transfers less any gift taxes paid. This calculation establishes a limitation on the Oregon inheritance tax. See unified rates from Table A in the instructions to the 2004 Form IT-1 attached in Exhibit 3).

2. Step 2 – Calculate the estimated Oregon Inheritance Tax. Apply the Oregon rates from 0.8 to 16.0% to the taxable estate as found on line 3, Part 2 of Form IT-1 less $60,000 to determine the maximum state death tax. (See rates from Table B in the instructions to the 2004 Form IT-1 attached in Exhibit 3).

3. Step 3 – The smaller of the amounts from steps 1 and 2 will equal the OTax.

4. Unexpected inheritance tax rate.[1] While the Oregon rate schedule appears low (0.8 – 16%), the actual tax rate follows the federal marginal rate of 39% to 41% for estates within ranges as follows:

a. 2004. 39% for estates between $850,000 and $924,000.

b. 2005. 39-41% for estates between $950,000 and $1,038,000. 39% on the first $50,000 over $950,000 and 41% on $38,000, the amount over $1,000,000.

5. Example for 2005 where no federal tax is due or filing required but an Oregon IT-1 and OTax would be paid at a blended rate of 39%:

Taxable Estate	$1,020,000	
Table A Tax		
Tax on $1MM	345,800	
$1,020MM – 1MM		
41% X $20K	8,200	
Table A Tax	$354,000	
Less Max Credit	($326,300)	
Net Table A Tax	$27,700	**(Smaller of the two calculations)**
Table B Tax		
$1,020MM – 60K =		
$960K		
Tax on $840K	27,600	
960K - 840K =		
$120K X 5.6%	6,720	
Net Table B Tax	$34,320	
Net Oregon Tax =	**$27,700**	

* Note that the blended rate applicable to the Gap is actually 39% in this example. The Gap equals 70,000 (1,020,000 – 950,000). The tax equals 27,700. The rate equals 39% ($27,700 ÷70,000).

6. The effect of lifetime gifts. The state death tax credit calculation is based upon the decedent's "adjusted taxable estate" ("ATE") (see I.R.C. Sec 2011). The ATE generally consists of the assets owned by the decedent at death plus assets brought into the estate under Sections 2035 (deathbed gifts and releases), 2036 (incomplete transfers) and 2038 (retained interests) without adjustment for taxable lifetime gifts. Although the calculation of the federal estate tax includes taxable lifetime gifts, such gifts are not included

[1] See David C. Streicher, "39% Oregon Inheritance Tax Rate?", *Accountant Magazine*, November 2004, for a discussion of this issue as it applies to both 2004 and 2005.

in the OTax calculation and therefore escape OTax. Planning opportunities arise in the following situations:

a. Estates under the federal filing requirement but subject to Oregon filing. If an estate exceeds the Oregon filing threshold but falls below the levels that require a federal filing, the individual should consider a lifetime gift of an amount that would reduce the estate below the Oregon filing requirement even as a deathbed gift. The result of such a gift would be that neither a federal nor any Oregon death tax return would need to be filed. An example for 2005 would be as follows:

Estate Value	$1,020,000
Gift	($100,000)
Oregon gross estate	$920,000

Since the Oregon gross estate must equal $950,000 in 2005, no Oregon death tax return need be filed for the estate in this example. Without the gift, the Oregon inheritance tax would have been $27,700 (see previous example in Article V. B. 5.). Because this gift is less than the $1 million maximum under IRC §2505(a)(1), there is no federal gift tax. What is more compelling is that the gross estate is now $920,000 rather than $1,020,000. Since the gross estate is less than $950,000, no IT-1 is due. Since there is no federal estate tax due, there will be neither federal nor Oregon tax to pay. Essentially, the savings of a deathbed gift would equal $27,700.

b. Lifetime gifts in estates exceeding the federal filing threshold. If the gross value of an estate exceeds the federal filing threshold with the inclusion of previous taxable gifts, the Oregon inheritance tax calculation works as follows:

	Lifetime Gift		**No Gift**
Table A Tax:			
Federal gross estate	$2,000,000		$3,000,000
Previous taxable gifts	$1,000,000		$0.00
Subtotal	$3,000,000		$3,000,000
Tentative Oregon tax (Table A)	$1,290,800		$1,290,800
Less gift tax payable (federal)	(0)		(0)
Gross estate tax	$1,290,000		$1,290,000
Less: 2005 credit	($326,300)		($326,300)
Net Table A tax	$964,500		$964,500
Table B Tax:			
Amount on line 3 IT-1	$2,000,000		$3,000,000
Less:	($60,000)		($60,000)
Oregon Adj. taxable estate	$1,940,000		$2,940,000
Tax on $1,540,000	$70,800	on $2.540M	$146,800
Tax on ($1,940,000 – $1,540,000) @ 7.2%	28,800	($2.94M - $2.54)@ 8.8%	$35,200

Net Table B Tax	$99,600 ←	**Smaller of the two**	$182,000
Oregon Inheritance tax	**$99,600**		**$182,000**
Oregon savings from gift	**$82,400**		

c. Valuation discounts. The proper use of valuation techniques may reduce the value of the estate below the filing level. For example, creating tenancy in common interests in real estate between spouses or family members may provide sufficient discounting (e.g. 15%+/-) to reduce the value of the gross estate below $950,000 (the 2005 OTax filing level). The use of entities such as family limited partnerships or LLCs may provide greater discounts. The negatives include the cost of an appraisal (usually insignificant when compared to the OTax) and the loss of basis step up at death if lifetime gifts of interests are given away to reduce the gross estate below the filing level.

VI. The Tax Dilemma.

A. Single individuals. The effect of decoupling on single intervals will be to impose OTax on smaller estates. Aside from lifetime gifts and moving to another state that lacks an inheritance tax, a single Oregonian simply pays more tax.

B. Married couples. The real tax dilemma created by HB 3072 is manifest most often with married couples, upon the death of the first spouse. Because of the difference in exemption between the federal estate tax under EGTRRA and the OTax under HB 3072, prototypical "reduce to zero" funding formulas designed to take advantage of the exemption and marital deduction in concert may no longer be effective to avoid the payment of any estate or inheritance tax at the first death.

C. Taxing the GAP. The prototypical funding formula, whether a pecuniary lead credit shelter or marital share or a fractional share, generally is designed to fund the credit shelter share in an amount equal to the Federal Exemption under IRC §2010. The Oregon Exemption amount under HB 3072, however, continues to relate back to the pre-EGTRRA Federal Exemption amounts, reflecting the following differences:

Year	Federal Exemption	Oregon Exemption	O Tax on the GAP Amount
2005	$1,500,000	$950,000	$64,400
2006	$2,000,000	$1,000,000	$99,600
2007	$2,000,000	$1,000,000	$99,600
2008	$2,000,000	$1,000,000	$99,600
2009	$3,500,000	$1,000,000	$229,200
2010	Unlimited	$1,000,000	N/A – Oregon Tax Only – No GAP
2011	$1,000,000	$1,000,000	0

Even though this discrepancy appears to resolve itself in 2011 under EGTRRA, rest assured that by that time, the federal law will have substantially changed, and it is likely that Oregon will not have connected to those prospective changes.

D. The Oregon QTIP. Because of this difference between the Federal Exemption and the Oregon Exemption, many existing estate plans for married couples simply will not work to reduce all taxes to zero at the first death. In recognition of this problem, section 6 of HB 3072 amended ORS 118.010 to add a new section (7), as follows:

> "If the federal taxable estate is determined by making an election under Section 2032 or 2056 of the Internal Revenue Code or another provision of the Internal Revenue Code, or if a federal estate tax return is not required under the Internal Revenue Code, the Department of Revenue may adopt rules providing for a separate election for state inheritance tax purposes."

In essence, the legislature authorized the Department of Revenue to promulgate rules regarding taking a special Oregon marital deduction or a special Oregon alternate valuation date election in order to ameliorate the adverse effects of the passage of HB 3072 as it applies to current planning. In response to those provisions, Oregon Administrative Rules were adopted by the Oregon DOR on April 30, 2004. The DOR Rules, which became effective on May 1, 2004, are attached to this outline as Exhibit 4-6.

E. Making the Oregon election. Under DOR Rules, Administrative Rule no. 150-118.010(7) provides for special elections under IRC sections 2031(c), 2032, 2032A, 2033A, 2056 and 2056(A) (see Exhibit 5). An Oregon election, once made, will be irrevocable. If a 706 is not required and if the election is made for Oregon purposes only, the Oregon election must be made on the Oregon return in the same manner as required under the Code as though made on the 706. It is interesting to note that the Administrative Rule does not provide for a method of making the election if a federal return is filed and the election is not made for federal estate tax purposes. However, presumably the election can be made on an IT-1 for Oregon purposes and will still be effective, even in the absence of a corresponding federal election.

1. QTIP qualification. In further explaining the election, however, the Administrative Rule provides that an Oregon QTIP election cannot be made unless the share subject to the election otherwise qualifies for QTIP treatment under IRC §2056(b)(7), as in effect on December 31, 2000.

2. Inclusion of Oregon GAP QTIP at survivor's death. If a QTIP election is allowed at the death of the first spouse, then the estate of the surviving spouse must include the value of the property subject to the Oregon QTIP election as required by IRC §2044. The Administrative Rule specifically provides that at the second death, the surviving decedent's gross estate for Oregon and Federal purposes will be different because of the "Oregon only" QTIP election. In other words, the GAP amount will be taxable in Oregon at the second death.

3. Administrative expenses. A separate issue arises, as well, under *IRC §642(g)*, which states:

> *"Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of the decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054."*

Generally, the personal representative will elect not to take deductions on the 706 for the estate of a first spouse to die with a "reduce-to-zero" federal funding formula, since this will result in no benefit being derived from the deduction for administrative expenses on the 706. Instead, the personal representative will elect to deduct these expenses against income on the fiduciary income tax return for the estate or trust. These considerations may be quite different, however, if the personal representative or trustee is working with a document which funds the credit shelter amount to the Federal Exemption, and as a result, is facing OTax. It may be more beneficial for the personal representative in that case to deduct expenses of administration on the OTax return, while deferring the deduction for those expenses of administration for federal purposes until the filing of the federal fiduciary income tax return. This will result in an Oregon fiduciary adjustment on the Oregon fiduciary income tax return for the estate or trust.

F. Working with the rules. How, then, do these rules work as a practical matter?

1. Administrative expense deduction considerations. First, we will focus on the rule under OAR 150.316.272 (see Exhibit 6), providing that certain deductions may not be taken on both the OTax and fiduciary income tax returns, but that an election

must be made to take advantage of those deductions on one return or the other. The following chart reflects a comparison of the OTax rates to the Oregon income tax rates, based upon certain sizes of Oregon taxable estates. The Oregon income tax rates are:

Income from	**Rate of Tax**
$ 1 - 2,500	5%
$ 2,501 – 6,250	7%
$ 6,251 or more	9%

2. Analysis. Presume administration expenses of $10,000 are incurred in 2005 for a decedent who died in 2005, and a calendar year income tax return is elected.

		Form 41 Taxable Income		
Value of Oregon Taxable Estate	OTax Bracket	$0-$2500 (5% bracket)	$2501-$6250 (7% bracket)	$6241 – up (9% bracket)
*$950,001-$1,038,000 (No FET so deduct on 1041)	*Deduct on IT-1	*Deduct on IT-1	*Deduct on IT-1	*Deduct on IT-1
$1,038,001-1,100,000* (No FET so deduct on 1041)	5.6%	Deduct on IT-1	Deduct on 41	Deduct on 41
$1,100,001-$1,500,000 (No FET so deduct on 1041)	6.4%	Deduct on IT-1	Deduct on 41	Deduct on 41
$1,501,000-1,600,000 (Fed. Deduct on 706)	6.4%	Deduct on IT-1	Deduct on 41	Deduct on 41
$1,601,000-2,100,000 (Fed. Deduct on 706)	7.2%	Deduct on IT-1	Deduct on 41	Deduct on 41
$2,100,000 – 3,600,000 (Fed. Deduct on 706)	8.8%	Deduct on IT-1	Deduct on 41	Deduct on 41
$3,600,001- up	9.6%-16%	Deduct on IT-1	Deduct on 41	Deduct on 41

*From $950,000 - $1,038,000 the actual OIT bracket is 39-41%, so always deduct on IT-1.

3. Preliminary conclusions. Note that the conclusions below do not take into effect the necessary draw-down of the credit shelter share when administrative expenses are deducted on the 41, and the resulting increase in estate tax of the second spouse to die.

a. As can be seen from the above schedule, when the Oregon taxable estate for OTax purposes is below $1,038,000 the administration expenses should probably be deducted on Form 41.

b. From that point forward, when the OTax is 5.6% (for Oregon estates of $1,038,000 to $1,100,000) if the fiduciary has taxable income of $2,500 or less (putting the fiduciary in the 5% income tax bracket), then the deduction is best taken on the inheritance tax return for the bigger (5.6%) benefit. However, to the extent that income of the fiduciary creeps into the 7% or 9% brackets, then the deduction on the 1041 may still be advisable.

c. When the taxable estate goes from $1,100,001 - $1,500,000, putting the estate in a 6.4% bracket, the results do not change.

d. The same result entails with respect to Oregon taxable estates from $1,500,001 – $1,600,000, even though these estates will be subject to federal estate tax. Since the federal estate tax bracket is 45%, the deduction should always be taken on the 706.

e. However, from $1,600,001 to $2,100,000 when the OTax bracket is 7.2%, then the practitioner may consider deducting administration expenses on the IT-1, to the extent that the taxable income of the estate is no higher than the 7% bracket.

f. This changes, however, when the estate value is $3,600,001, or more, at which time the deduction should probably always be taken on the IT-1, no matter how much fiduciary income has been generated by the estate.

VII. <u>Legislative Proposals</u>. The Oregon State Bar has recently proposed a bill that would further define and resolve some of the issues regarding the Oregon QTIP election. A copy of this proposed legislation, known as LC 470 submitted on September 2, 2004, is attached as Exhibit 7 to this outline. The legislation attempts to resolve the following issues:

A. Oregon GAP QTIP. With respect to GAP Estates, section 2 of the proposed bill establishes a process for creating what is tantamount to an Oregon QTIP. The Oregon QTIP will be called "Oregon special marital property." The value of the taxable estate for Oregon will be the taxable estate determined for federal tax purposes, reduced by the date of death value of Oregon special marital property.

1. Oregon special marital property. Oregon special marital property will consist of any trust or other property interest, or portion thereof, in which principal or income may be accumulated or distributed to or on behalf of only the surviving spouse during his or her lifetime, and in which no one may transfer or exercise a power to appoint any part of the trust or other interest to someone other than the surviving spouse during his or her lifetime. In addition, the executor of the estate is required under this provision to make an election in order to qualify the trust as Oregon special marital property.

a. The election is made by attaching a statement to the Oregon return (i) identifying the property interest constituting Oregon special marital property, (ii) confirming that it meets the requirements of Oregon special marital property, and (iii) confirming that the property will be administered as Oregon special marital property, or that it will be administered in such other manner as the DOR may require.

b. If a trust or other interest in property will qualify as Oregon special marital property, except that principal or income is distributable under the trust to someone other than the surviving spouse, an Oregon special marital property election can still be made as against a portion or share of the property or interest, if the executor makes the election described above, and if each living beneficiary who is entitled to distributions during the lifetime of the surviving spouse, and the surviving spouse himself or herself, make a special election. The elections must be attached to the IT-1 or filed or maintained as records otherwise prescribed by the Department of Revenue through its rulemaking authority.

c. The proposed form of election by beneficiaries other than the spouse shall be in substantially the following form under the proposed bill:

CONSENT TO ESTABLISHMENT OF
OREGON SPECIAL MARITAL PROPERTY

ELECTION TO BE SIGNED BY ALL BENEFICIARIES EXCEPT THE SURVIVING SPOUSE: Each of the undersigned acknowledge and consent to a portion of the _____(name of trust or other property interest) being set aside as a separate share or trust in order to qualify for the Oregon special marital property election in accordance with section 2 of the 2005 Act, for the primary purpose of reducing or eliminating the Oregon Inheritance Tax due on the estate of _____ (name of decedent). The undersigned together with the surviving spouse constitute all of the persons living on the date of this election who may be entitled to a distribution during the lifetime of the surviving spouse from the ___ (name of trust or other property interest). Each of the undersigned, both on behalf of the undersigned and on behalf of the unborn lineal descendants of the undersigned, irrevocably agrees to release all rights to distributions from the Oregon special marital property during the lifetime of the surviving spouse. Each of the undersigned agrees that all other provisions of the ____ (name of trust or other property interest) shall remain in effect and that, upon the death of the surviving spouse, any remaining Oregon special marital property shall be distributed as otherwise provided in the trust or other property interest.

Signature of: _____ (beneficiary)

Signature of: _____ (beneficiary)

d. The election to be signed by the surviving spouse should be in substantially the following form under the proposed bill:

ELECTION TO BE SIGNED BY THE SURVIVING SPOUSE: I am the surviving spouse of _____ (name of decedent). I acknowledge and consent to a portion of the _____ (name of trust or other property interest) being set aside as a separate share or trust in order to qualify as Oregon special marital property under section 2 of the 2005 Act, for the primary purpose of reducing or eliminating the Oregon Inheritance Tax due on the estate of _____ (name of decedent). I, together with all of the other individuals executing the election in accordance with section 2 of this 2005 Act, constitute all of the persons living on the date of this election who may be entitled to a distribution from the Oregon special marital property to which this election applies and who might be entitled to a distribution during my lifetime. I agree that all other terms, conditions and provisions that apply to the _____ (name of trust or other property interest) shall apply to the Oregon special marital property to which this election applies, and that upon my death, any remaining Oregon special marital property shall be distributed as otherwise provided in the trust or other property interest.

Signature of: _____ (surviving spouse)

SUBSCRIBED AND SWORN TO before me this ___ day of _____, 200__.

_____
Notary Public for Oregon
My Commission Expires:

e. Any elections made under the proposed legislation are irrevocable.

f. With respect to elections to be made by minors, the custodial parent or court appointed guardian of any minor beneficiary can sign the election both on behalf of the minor beneficiary and on behalf of the unborn lineal descendants of the minor beneficiary. This obviates the necessity of hiring a Special Representative under ORS 128.179(1)(a).

g. It is important to note that paragraph (2)(a) of section 2 of the proposed bill provides for a subtle but important difference from the QTIP rules under IRC §2056(b)(7). Under the Code, all of the income of the QTIP trust must be payable to the surviving spouse at least annually. Under the proposed bill, income may be accumulated for the benefit of only the surviving spouse during the spouse's lifetime, and there is no requirement that the income be paid out at regular intervals. *Query*, at the death of the surviving spouse, must all of that income be paid to the surviving spouse's estate? If not, the new Oregon special marital property rule essentially provides for a discretionary income trust to qualify for the Oregon special marital property election, so long as there are no beneficiaries other than the surviving spouse during the spouse's lifetime, without the requirement that accumulated income be paid out of the spouse's estate.

2. Planning during the interim. It should be noted that the proposed legislation is substantially different than the current law regarding the Oregon special election for the GAP portion under OAR 150.118.010(7)(1). That rule specifically provides that "If a federal estate tax return is not required with respect to the decedent's death, the Oregon elections must be made in the same manner as required under the IRC on a return filed with the Oregon Department of Revenue." (Emphasis added). In other words, unless the new legislation is passed, the special Oregon QTIP rule will only apply to a credit shelter trust which currently qualifies for the federal estate tax marital deduction under IRC §2056. In many cases, credit shelter trusts provide for discretionary income distributions to the surviving spouse, and often provide for distributions to children and other non-spouse beneficiaries.

3. What happens next? What do we do if the proposed legislation does not pass? Even if the legislation does pass, it will not be submitted until the 2005 legislature, and will not be effective until 2006. How does this affect existing deaths in 2005?

a. Probably the easiest approach, if available, will be correcting the non-qualifying interests through the use of qualified disclaimers under IRC Section 2518.

b. Perhaps one alternative would be the preparation of an agreement modifying the trust under ORS 128.177.

(1) Under ORS 128.177, an agreement can be entered into between the grantor, if living, the trustee, and all persons who have a beneficial interest in the subject of the agreement (including the Attorney General if the trust is a charitable trust) modifying the trust instrument, including extending or reducing in the period of operation, if the modification is not inconsistent with any dominant purpose or objective of the trust. In the case of a discretionary credit shelter trust, the trustee and beneficiary could prepare an agreement modifying a trust to require mandatory income to be paid to the spouse only, with no distribution to beneficiaries other than the spouse during the spouse's lifetime. This modification would be focused upon reliance on the phrase the "dominant purpose" in ORS 128.177(1)(d). Although a person could determine that one purpose of the trust was to provide for distributions to non-spouse beneficiaries, the overriding or dominant purpose of the trust, it seems, is to avoid the incidence of estate and inheritance tax at the first death. Typically, this is the reason credit shelter trusts are created.

(2) Any petition for modification would probably require the appointment of a Special Representative to represent a minor, incompetent, unborn or unascertained beneficiary under ORS 128.179(1)(a). Although this process may be cumbersome, the Trustee and beneficiaries could draft an amendment or modification to the trust, petition the court for the appointment of a Special Representative to represent the minor, unborn or unascertained beneficiaries, and together with the Special Representative, modify the trust so that it qualifies under IRC §2056 (b)(7) as a QTIP trust.

b. If the client is concerned that a self-serving agreement modifying the trust to conform to the QTIP rules would not be sufficient to avoid Oregon taxes on the GAP, another, and perhaps more credible method of resolving the issue, could be actually seeking the authority of a court under ORS 128.135. Under that section, any beneficiary or trustee of a trust has the right to petition the circuit court in any county where the trust assets are located or where the trustee resides for any of a number of purposes, including the making of any modification of the trust that the parties could make by agreement under ORS 128.177 cited above. ORS 128.135(1)(d).

(1) The procedures for following this approach are the same as those provided in ORS 111.205 to 111.235 regarding interested parties petitioning the probate court in a decedent's estate.

(2) If an ORS 128.135 proceeding is pursued, notice must be given to all living beneficiaries and the currently acting trustee as provided under ORS 111.215, giving the beneficiaries the right to object and seek a hearing.

(3) Although the practitioner will have to convince the court that the modification is consistent with the objectives of the trust, once the court "buys into" that analysis, its order is final, conclusive and binding upon all beneficiaries notified in the proceeding, including incompetent, unborn and unascertained beneficiaries. For that purpose, ORS 128.135(7) provides that every unborn or unascertained beneficiary is bound by actions taken by the court for or against any living beneficiary of the same class or whose interests are similar to the interests of the unborn or unascertained beneficiary.

B. The better alternative. Although ORS 128.135 proceedings or ORS 128.177 agreements regarding modification may provide an escape valve to modify a credit shelter trust to conform a QTIP trust under IRC §2056(b)(7), the much better alternative would be passage of the proposed legislation authorizing the establishment of Oregon special marital property.

C. Remaining unanswered issues under the proposed bill. However, presume for a moment that the bill becomes law. A number of issues would be created with the Oregon special marital property designation, which has not been addressed by this state.

1. Identification of property. How does one continue to identify Oregon special marital property? Is there a requirement that the property be maintained in a special share of the credit shelter trust and held and administered as a separate trust by the trustee during the surviving spouse's lifetime? No such requirement currently exists.

2. Change of trust situs. What if the trust changes its situs to another state, say, Nevada? How does Oregon enforce inclusion of the trust in the surviving spouse's Oregon estate at the time of the surviving spouse's death?

3. Nominal amounts in the Oregon share. What if, instead, the surviving spouse moves to Nevada but maintains the Oregon special marital property trust in Oregon, and at the surviving spouse's death the trust only has a nominal amount of property? Since the spouse has moved most of his or her assets to a non-taxable jurisdiction, does this render the Oregon special marital property also non-taxable because it is well below Oregon's exemption amount? It appears not, so long as the gross estate is greater than $950,000. But who will report the death to Oregon?

4. Policing the movement of Oregon special marital property. Is there some system of reporting the movement of Oregon special marital property out of the state? Will there also be some system of reporting non-Oregon special marital property owned by a surviving spouse who is also the beneficiary of a trust holding Oregon special marital property to determine the spouse's Oregon gross estate?

5. Further rules needed. It is the opinion of the authors that without further legislation or administrative rules, if a taxpayer wants to, he or she could very easily take steps to make it nearly impossible for the state of Oregon to collect its tax on Oregon special marital property. The alternative, however, would be the establishment of a trust to hold Oregon special marital property which is not unlike a qualified domestic trust under the Code. As soon as the property is removed from the jurisdiction of the state of Oregon, the property would be taxed. But at what rate? And how would the state of Oregon know when the property has been moved? Would there be some sort of asset freezing technique involved? These troubling issues have not even been addressed by the Department of Revenue and it is likely that they will persist into the future.

6. Total return unitrusts. Will Oregon allow a total return unitrust to serve as a qualifying interest for QTIP purposes? The Department of the Treasury, in TD 9102, provided that a total return unitrust which, if administered under applicable state law, provides for a reasonable apportionment of the total return of a trust between the income and the remainder beneficiary, will meet the requirements of the QTIP regulations for both gift and estate tax purposes. Oregon recently passed legislation authorizing the use of 4% total return unitrusts in lieu of mandatory income trusts. ORS 129.225(4). Questions have arisen regarding whether or not these type of trusts would qualify for an Oregon QTIP election or would qualify as Oregon special marital property under the proposed bill. Since the federal change reflects a new interpretation or amendment of the federal law which existed prior to the enactment of EGTRRA, the officials at the Oregon Department of Revenue have tentatively indicated that they will follow the change in the federal law.[2]

D. Other Oregon elections. If the practitioner faces a tax on the GAP, OAR 150-118.010(7)(1) provides for additional special Oregon elections which would otherwise be available under the federal law.

[2] See Jeffrey M. Cheyne, Oregon Inheritance Tax Disconnect, Oregon State Bar CLE, page 2-15.

1. Qualified conservation easements. Under IRC §2031(c), an exclusion of up to $500,000 is available for the applicable percentage of land subject to a qualified conservation easement. The "applicable percentage" is 40% reduced by 2 percentage points for each percentage point by which the conservation easement is less than 30% of the value of the land (but not below 0). A number of certain other restrictions and definitions apply. If an executor or decedent is contemplating a conservation easement, even though there may be no federal estate tax due, depending upon the size of the estate the executor may wish to make a qualified conservation easement election against the GAP portion.

2. Alternate valuation date. IRC §2032 provides for the alternate valuation date determination, which basically fixes the value of an estate for federal estate tax purposes as the fair market value of the assets six months following the date of the decedent's death. The election is only available to the extent the election reduces federal estate taxes.

a. Under the administrative rule, a separate §2032 election can be made for Oregon purposes only. Since the administrative rule specifically refers to IRC §2032, it can only be presumed that IRC §2032(c) will not apply. That is the provision which authorizes alternate valuation date to be used only if the gross estate is reduced and federal estate tax is reduced.

b. If §2032 is elected for Oregon purposes, does that mean that we now have different tax bases in assets for federal and Oregon purposes? It appears that the answer is "yes." This would mean that depreciation and gain and loss and computations would be different for federal and Oregon purposes. These federal/Oregon differences would create additional bookkeeping headaches and significantly impact decisions regarding the sale or exchange of certain assets.

c. If the death occurs after 2009, then a question arises regarding whether or not the basis differences would still occur. Although Oregon specifically disconnected from the estate tax rules under EGTRRA, the authors find nothing under HB 3072 which disconnects Oregon from the EGTRRA rules repealing the basis step-up after 2009. Special federal rules under EGTRRA apply to minimal step-ups in basis for bequests to surviving spouses and others, but the step-up is limited, as compared to existing §1014(a). *Query*, if an Oregon special marital property election is made, would there be a similar federal/Oregon tax difference because of the new special basis rules after December 31, 2009 embodied in IRC §1022?

(1) Under that section, although carryover basis will prevail, a minimum basis increase of $1.3 million will be applicable to property acquired from a decedent. In addition, qualified spousal property under IRC §1022(c)(1) will receive a basis increase of $3 million if it was an outright transfer to a spouse or a QTIP transfer.

(2) In the year 2010, if there is no federal estate tax, yet there is a $1 million Oregon inheritance tax exemption, would it be prudent in any event to

create an Oregon credit shelter trust of $1 million, an Oregon special marital trust of $300,000 (taking into account the remaining basis increase) and allocating the remainder of the estate to the surviving spouse or a QTIP trust for the surviving spouse, and receive another $3 million basis increase against that property? Since these rules have yet to be formulated, and it is likely that Congress will again meet and change the rules before that time, it may not make tremendous sense to agonize too deeply over these questions. However, they raise interesting inquiries with respect to planning for Oregon, if, in fact, these rules do not change.

E. Special use valuation. IRC §2032A provides for a reduction in the value of certain qualified use property not to exceed $750,000 multiplied by a cost of living adjustment from 1997. The current potential reduction is $850,000. Although a qualified use election may not be appropriate for federal purposes, it may be appropriate to consider a §2032A election for the GAP for OTax purposes. Because the section 2032A rules are so restrictive and require continuous reporting, it may not be worthwhile to take advantage of these rules for the sole purpose of reducing the Oregon GAP. If, however, the estate is large enough to be subject to federal tax, the §2032A election may be useful to allocate more empirical value to the credit shelter trust and less to the marital share, thereby reducing eventual estate taxes at the second death.

F. The QFOBI deduction. IRC §2057 provides for the qualified family owned business interest ("QFOBI") deduction. However, this was repealed by EGTRRA for the years 2004 and thereafter. This is principally due to the fact that under the federal rules, the combination of the QFOBI deduction and the Federal Exemption under IRC §2010 cannot exceed $1.3 million. Since the Federal Exemption amount under EGTRRA increased to $1.5 million in 2004, the QFOBI election no longer had any "teeth." However, since the Oregon Exemption is only $950,000 in 2005, there is still a $350,000 GAP between a maximum QFOBI amount and the Oregon Exemption. The instructions to the IT-1 for 2004 (at page 6) specifically provide for a QFOBI deduction. If the QFOBI deduction is $675,000, the Federal Exemption will be limited to $625,000, so the unified credit entered on the return would only be $202,050. Since the Oregon Exemption is $950,000 in 2005, the QFOBI deduction would basically be limited to $350,000 (the difference between the $1.3 million total and the $950,000 Oregon Exemption). For years 2006 and thereafter, the QFOBI deduction would be $300,000 (the difference between the $1.3 million total and the $1 million maximum Oregon Exemption). If the QFOBI deduction exceeds $300,000 in years 2006 or thereafter, the Oregon Exemption will be reduced by the excess, so that the $1.3 million combination of QFOBI deduction and exemption is maintained.

VIII. Planning for the Gap. Now that we have looked at the history and proposals for future planning, how do we advise our client's to address the decoupled federal and state death tax systems? What advice do clients implement during their lifetime planning? How do we update old documents for clients? How do we draft documents for clients with property in multiple states, each with differing inheritance tax approaches? Should the drafting focus only on testamentary documents or should we consider placing provisions into

inter vivos documents? Here are a number of general considerations with some specific approaches gathered from a number of sources:

A. Documentation for lifetime giving. The approaches taken for estate planning for single and married clients may differ, however, the planner should provide for authority and flexibility in the documentation to adapt and administer estate plans whether or not the clients are competent to do so themselves. Generally, one should include broad powers to make gifts in both the power of attorney and revocable living trust to provide authority to make appropriate gifts to save taxes while including limits on such gifts that are consistent with the client's pattern of gifting or the client's estate plan.

B. Single clients.

1. Power of attorney and living trust and lifetime gifts. Because of the advantages obtained from excluding lifetime gifts from the OTax base for individuals who will not benefit from estate tax deferral through gifts to a surviving spouse, powers to make gifts, even death-bed gifts, should be considered in both the power of attorney and living trust, assuming a client who because of age or incapacity could not accomplish the gifts on their own.

2. Importance of lifetime and deathbed gifts. A lifetime gifting strategy may be very appropriate for a single individual whose remaining lifetime economic needs would be unaffected by the transfer of the gifted assets. A deathbed gift that reduces the threshold for filing an Oregon inheritance tax return would be very effective, however, a gifting strategy saves OTax even when a 706 includes lifetime taxable gifts in the calculation of federal estate tax which results in federal estate taxes at death. Even though this is an often uncomfortable and delicate subject to broach, significant tax savings can be accomplished.

C. Married couples – two techniques.

1. Lifetime credit shelter trust funding. One gifting technique to be considered by married couples involves funding a credit shelter trust by the wealthier spouse for the less wealthy spouse during lifetime. The wealthier spouse could fund a credit shelter trust with the current amount exempt from OTax ($950,000 in 2005) and direct the difference between the Federal Exemption and the amount exempt from OTax ($1,500,000 - $950,000 = $550,000 in 2005) in their will or trust to add to the credit shelter trust at death. The effect of this would be to exclude the $950,000 from the OTax as well as the additional $550,000 since the lifetime gift is not included in the OTax base and the additional gift is below the amount exempt from OTax at death. This saves $64,400 in OTax on the $1,500,000 combined funding assuming death occurs in 2005. The remaining $50,000 ($1,000,000 maximum OTax exemption in 2006 less the $950,000 funding in 2005) could be added to the trust in the following year to maximize the credit shelter trust funding during lifetime. When the Oregon Exemption increases to $1,000,000 in 2006, a lifetime funding of

$1,000,000 to the credit shelter trust followed by an addition of $1,000,000 at death will save $66,400 in OTax.

2. Contingent lifetime QTIP trust funding. This technique allows the less wealthy spouse to fund a credit shelter trust, either during lifetime or upon their death.[3] Wealthy spouse creates a trust for less wealthy spouse. The trust exclusively benefits the beneficiary spouse. The trust pays all income to the beneficiary spouse but the donor spouse retains a limited power of appointment over all undistributed trust assets, making the gift incomplete. All trust distributions to the beneficiary spouse qualify for the gift tax marital deduction without a QTIP election or need to file a gift tax return. Upon the death of the first spouse to die, the limited power of appointment terminates. The following occurs if the donor spouse dies first:

a. QTIP election on federal estate tax return and fund the credit shelter trust with other assets, or,
b. No QTIP election and qualify the trust as a credit shelter trust.

If the beneficiary spouse dies first, the following occurs: The donor spouse makes a QTIP election on a federal gift tax return and the trust becomes the deceased spouse's credit shelter trust.

The IRS takes the position in the PLRs that the QTIP gift that takes effect on the beneficiary spouse's death qualifies for the gift tax marital deduction.

D. Residency changes coupled with entity planning. The OTax applies to property within the jurisdiction of Oregon; however, the tax net is broader for property of Oregon "residents".[4] The OTax applies to property of nonresidents only as to property within Oregon.[5] The reference to "residency" is misleading as the critical factor is "domicile".[6] Domicile is a state of mind, that is, one's "intent" to maintain a true, fixed, permanent home, even though absent for short or even long periods of time.[7] Evidence of

[3] PLR 200403094. Robert Rosepink, Immediate Past President of ACTEC has filed a request for revenue ruling on this technique in 2004 for authority on which practitioners may rely (see Exhibit 9).

[4] ORS 118.010(3) In the case of a resident decedent owning property outside of the jurisdiction of this state at the time of death, the tax imposed under this section shall be the amount determined under subsection (2) of this section multiplied by a ratio. The numerator of the ratio shall be the sum of the appraised value of the decedent's real property located in Oregon, tangible personal property located in Oregon and intangible personal property located both in and outside of Oregon. The denominator of the ratio shall be the total appraised value of the decedent's gross estate.

[5] ORS 118.010(4)(a) In the case of a nonresident decedent owning property within the jurisdiction of this state at the time of death, the tax imposed under this section shall be the amount determined under subsection (2) of this section multiplied by a ratio. The numerator of the ratio shall be the sum of the appraised value of the decedent's real property located in Oregon, tangible personal property located in Oregon and intangible personal property located in Oregon. The denominator shall be the total appraised value of the decedent's gross estate.

(b) Intangible personal property of a nonresident decedent shall not be included in the numerator of the ratio used to determine the tax under this subsection if a similar exemption is made by the laws of the state or country of the decedent's residence in favor of residents of this state.

[6] ORS 118.005(9) "Resident decedent" means an individual who is domiciled in Oregon at the time of death.

[7] OAR 150-316.027(1) (a).

domicile can be found by examination of family, business and social connections with Oregon.[8] Clients willing to change domicile to a coupled state or state without an inheritance tax and also willing to move all of their property out of Oregon will avoid the OTax. If they hold Oregon real estate, they should couple the move with entity planning. If the client holds interests in real property and transfers title to an entity domiciled in such foreign jurisdiction (such as a corporation, LLC or partnership), then the interest in the real property transforms to intangible personal property and Oregon loses jurisdiction to tax.[9]

E. Notification of Clients. Because clients and their heirs may experience unexpected and unplanned OTax in an estate administration, the prospect for potential difficult discussions between the planner and the estate administrators and/or heirs is likely. Should the practitioner notify their clients of this problem or not? If one chooses to notify clients, they might consider using a sample letter attached as a basis for a follow up discussion regarding planning for the GAP (see Exhibit 8).

IX. Drafting for the GAP.

After advising client about implementing planning to address the GAP during their lifetime, the proper documentation should immediately be addressed for documents passing property at death. Many alternatives can be used. Some of those we have drafted or borrowed from our colleagues are addressed here.

A. Fund to lesser of Federal or Oregon Exemption. Another alternative to deal with the Oregon GAP problem is to have a clause eliminating all taxes at the first death, both federal and Oregon. This clause would require a formula that reduces the credit shelter trust to the lesser of the existing Federal or Oregon Exemption amount on the date of death of the first spouse. A pre-residuary marital formula taking this language into consideration might read as follows:

> *If my spouse, (spouse's name), survives me, then I give to my spouse, (spouse's name), the minimum pecuniary amount necessary as a marital deduction to eliminate entirely (or to reduce to the maximum extent possible) any federal estate tax and Oregon inheritance tax at my death, taking account of all deductions and credits available for estate or inheritance tax purposes, including, but not limited to, the maximum federal unified credit against estate tax available to my estate on the date of my death reduced by the amount of unified credit used by me on transfers made prior to my death, plus that part of my estate which will qualify for all other credits against the federal estate tax available to my estate, except any prior transfer tax credit which may be available to my estate as a result of the death of any individual who survives me.*

[8] See examples and definitions in OAR 150-316.027.
[9] ORS 118.010(4).

(a) In satisfying this gift, account shall also be taken of the net value of all other property included in my gross estate which passes or has passed, during my life or at death, under this Will or otherwise, to or for my surviving spouse so as to qualify for the federal estate tax marital deduction.

(b) For purposes of determining the amount of this gift, final federal estate tax values shall be controlling, and account shall not be taken of any credit to the extent it would cause the marital deduction available to my estate to be wholly or partially disallowed; nor shall account be taken of any debts, expenses of my last illness or expenses of administration of my estate to the extent that such debts, medical, or administrative expenses are not used as a deduction under Section 2053 of the Code or like provisions under Oregon law.

(c) All inheritance, estate, legacy, transfer, succession, or other death taxes (including interest or penalties thereon) payable by reason of my death, shall not be allocated to the share of property which passes to my spouse hereunder.

B. Disclaimers. A more simple drafting technique, but a more troubling method to keep control of at the first death, regards the use of disclaimers. The authors can think of two methods of using disclaimers to resolve the GAP problem at the first death.

1. Winner-take-all disclaimers to the credit shelter trust. The first method of using a disclaimer would be drafting a simple winner-take-all will, leaving everything to the surviving spouse and authorizing the surviving spouse to disclaim any amounts he or she deems appropriate. The disclaimed amount would fall into a credit shelter trust, which would qualify for the Oregon special QTIP election. The Federal Exemption could then be allocated to the full credit shelter trust, with a separate share of that trust being set aside for the Oregon special QTIP election.

2. Disclaim only to Oregon Exemption. In the alternative, the surviving spouse can disclaim only an amount necessary to fill the Oregon Exemption, and retain the balance. This would work effectively if the credit shelter trust would not qualify as a federal QTIP or if the proposed Oregon special marital property legislation does not pass. This would also work effectively in an estate where total assets of husband and wife are not expected to exceed $2 million, presuming both spouses die after 2005. The surviving spouse could disclaim $1 million at the first death, funding the credit shelter trust which would be exempt for both federal and Oregon purposes. The remaining $1 million would be exempt for both federal and Oregon purposes at the surviving spouse's death using the survivor's exemption, presuming no appreciation in the estate. Typical language creating a simple disclaimer may look something like this:

"I give the residue of my estate to my spouse, (spouse's name), provided that my spouse survives me. Should my spouse disclaim any interest

in my estate, then all such disclaimed interest, which shall include both principal and income, shall pass to _____, referred to in this Will as the Trustee, to be held in trust by the Trustee for distribution in accordance with the terms of the Credit Shelter Trust, Article ____, below."

Although this method provides optimum flexibility, it is not without its perils and pitfalls:

a. We presume, when drafting disclaimer documents, that the surviving spouse will be astute enough to contact his or her attorney at the first death and ensure that the Oregon Inheritance Tax and Federal Estate Tax Exemptions are adequately dealt with and that disclaimers are properly evaluated and made. Sometimes our clients do not always conform to our expectations.

b. Is there any duty created in the practitioner to advise the surviving spouse of different rights or obligations he or she may have at the death of the first spouse?

c. Does the estate practitioner have ethical considerations in advising the surviving spouse whether and to what extent a disclaimer should be made? If a disclaimer is made, the spouse may be divesting assets into a trust which guarantees rights for children or other beneficiaries. If these children are children of the deceased spouse from a previous marriage, an inherent conflict may arise. This is especially true in cases where the surviving spouse and the children of the decedent do not necessarily get along. Although the fiduciary must adhere to fiduciary duties owed to the beneficiaries, the exercise or non-exercise of a disclaimer and the attorney's advice to the person who is both the fiduciary and the holder of the right to disclaim does not, in and of itself, present an ethical issue for the practitioner. The mere fact that the attorney represents an individual in both their fiduciary and individual capacities does not present a multiple client conflict. The rule as provided by the Oregon State Bar is as follows:

"As we observed in OSB Legal Ethics Op No 1991-62, an attorney for a personal representative represents the personal representative and not the estate or the beneficiaries as such. It follows that when Attorney A represents Widow as an individual and Widow in her capacity as personal representative, Attorney A has only one client. Alternatively stated, the fact that Widow may have personal interests that may conflict with her fiduciary obligations does not mean that Attorney A has more than one client. For purposes of the rules regarding multiple client conflicts of interest, representing one individual in several different capacities is not the same thing as representing several different individuals. Consequently, the multiple client conflicts rules contained in DR 5-05(A), DR 5-105(E) and DR 5-105(F) do not apply to Attorney A's situation."[10]

[10] OSB Ethical Op No. 1991-119. See new Oregon Rules of Professional Conduct adopted by the Supreme Court of the State of Oregon in Order No. 04-44, effective January 1, 2005 (equivalent rule: ORCP Rule 1.7)

Of course, other ethical issues may arise under different fact scenarios.

d. The disclaimer must be made within 9 months following the decedent's date of death, and the surviving spouse cannot use or take advantage of the property prior to the disclaimer. If the spouse violates these requirements, the right to disclaim will be lost. In addition, a surviving spouse may not disclaim into a trust which gives the disclaimant a limited power of appointment.[11]

3. Disclaimer receptacle trust. Another form of disclaimer, which works equally as well as the form set forth above but which ensures the establishment of a credit shelter trust, would take the form of our standard complex A/B will. The will would provide for a fractional share or lead marital or residuary formula clause, based upon the Federal Exemption in the year of death. The marital share can either be an outright gift, QTIP, estate trust or power of appointment trust. The residual share, however, can take the form of a discretionary income credit shelter trust. The surviving spouse would then have the right to disclaim a portion of the credit shelter trust, presumably equaling the GAP amount. The disclaimed share of the credit shelter trust would drop into a "disclaimer receptacle trust," which would qualify as a QTIP under federal law. This is basically a three tiered structure, with a QTIP or marital fund for the surviving spouse, a discretionary credit shelter trust for the amount of the Oregon Exemption and a special Oregon disclaimer receptacle trust which would qualify for the balance of the Federal Exemption but serve as an Oregon QTIP trust to take care of the GAP. Special disclaimer language to authorize a share dropping down to a disclaimer receptacle trust might read as follows:

"ARTICLE _____. <u>Disclaimers.</u>

Any beneficiary under this Will may disclaim, in whole or in part, any gift, interest, right, or power hereunder. In the event of any disclaimer of any gift, interest, right, or power, or any portion thereof, the property over which such disclaimer is made shall be disposed of in the manner provided in this Will as if the person disclaiming had not survived me.

(a) If my spouse disclaims any interest in the Marital Trust created under this Will, all of the principal assets of the Marital Trust which are proportionately attributable to the income interest disclaimed by my said spouse, and all principal actually disclaimed by my said spouse, shall pass to _____, as the Trustee, IN TRUST, to be held by the Trustee upon the terms and conditions of my Credit Shelter Trust, set forth in Article ___, above.

[11] IRC §2041(a)(3); IRC §2514(d) (the "Delaware Tax Trap").

(b) If my spouse disclaims any interest in the Credit Shelter Trust created under this Will, all the principal assets of the Credit Shelter Trust which are proportionately attributable to the income interest disclaimed by my said spouse, and all principal actually disclaimed by my said spouse, shall automatically pass to _____, as the Trustee, IN TRUST, to be held by the Trustee upon the terms and conditions of my Disclaimer Receptacle Trust, as set forth in Article ____, below.

(c) If my spouse disclaims an interest under this Will, and absent a clear expression regarding which interest is being disclaimed, said disclaimer shall be construed to be a disclaimer of the interest of my spouse, to the extent of such disclaimer, in the Marital Trust, and not the Credit Shelter Trust.

(d) For purposes of this Article, a disclaimer shall be deemed to be effective whether made by the individual in whom the bequest or interest would otherwise vest, or whether said disclaimer is made by the guardian, custodian, attorney-in-fact, personal representative or other legal agent of said beneficiary.

C. Clayton QTIP and the Oregon QTIP.

1. Authority. Following the technique in two leading cases, *Estate of Clayton*, 97TC327, and *Estate of Robertson*, 98TC678, practitioners may wish to utilize a form now referenced to as the "Clayton QTIP." This form treats all property as qualified for the federal QTIP election so that estate and administrators may choose to elect the QTIP for the portion of property necessary to reduce tax to the designed level whether that be zero or a larger amount. The primary advantages of a QTIP election (over a disclaimer approach) are as follows:

a. The election can be made as late as fifteen months after death, assuming a timely filed extension for the estate tax return; and

b. The concern about tainting qualification for disclaimer by the supervisor's use of the property during the nine month period following the date of death is irrelevant.

2. Clayton QTIP language modified for an Oregon QTIP. The following language was developed in conjunction with my Davis Wright Tremaine colleagues (Chuck Mauritz, Shannon Connelly, Thomas Jones, and Erik Schimmelbusch) to provide an approach to preserve the full federal exemption while qualifying for the Oregon QTIP. We feel that the election should not be made by the surviving spouse even in a fiduciary capacity to avoid an argument for inclusion in the surviving spouse's estate. This language is taken from a single living trust of a wife for the benefit of her husband at death:

Distributions Upon Death of Trustor

1. Upon the death of the Trustor and after payment of the obligations and distributions described in the preceding Article, the Trustee shall apply the balance of the trust estate, including the balance of any assets then devised or transferred to the Trustee, pursuant to the following terms and conditions.

2. If (husband's name) survives the Trustor, the Trustee shall apply the trust estate pursuant to Paragraph 4 below (the "Marital Fund"); provided, however, any portion, asset or amount of the trust estate for which a marital deduction election for federal estate tax purposes is not made pursuant to Section 2056(b)(7) of the Code, shall be set aside in a separate share (the "Holding Fund") and shall be applied as provided in Paragraph 5 below.

a. For purposes of the division of the trust estate pursuant to this Paragraph 2, if any, values assigned to all assets shall be those finally determined for federal estate tax purposes.

b. Other than in the case of specifically identified assets for which the Section 2056(b)(7) election described above is not made, the Trustee shall have unrestricted discretion to determine what assets shall be allocated to the Holding Fund; provided, however, the Trustee shall first allocate to the Holding Fund, to the extent such assets represent a part of the trust estate, any asset with respect to which a marital deduction for federal estate tax purposes is not allowable due to its character or restrictions associated with it; and further provided, however, the assets allocated to the Holding Fund shall be valued at their respective fair market values on the date or dates of each allocation.

3. If (husband's name) predeceases the Trustor, the entire trust estate shall be applied pursuant to Article __ below.

4. The Marital Fund shall be applied as provided below.

a. The Trustee shall pay to or for the benefit of (husband's name), during his lifetime and through the date of his death, the entire net income of the Marital Fund. Such income shall be paid to (husband's name) at convenient intervals but not less often than quarterly. Further, (husband's name) may at any time require the Trustee to dispose of any asset of the Marital Fund.

b. The Trustee may pay to or for the benefit of (husband's name) such sums from the principal of the Marital Fund as the Trustee determines, in its discretion, to be reasonable and necessary for his health, support and maintenance.

c. If any residential real estate used by the Trustor as the Trustor's principal residence or for recreational or vacation purposes, or any interest therein or replacement thereof, is included in the Marital Fund, then (husband's name) shall be entitled to use and occupy such property or properties for the balance of his

lifetime after the death of the Trustor without the payment of rent therefor. In all other regards, the Trustee shall treat such property or properties as assets of this trust estate and shall be fully responsible for their repair, maintenance and care and shall discharge all financial responsibilities associated therewith.

d. Upon (husband's name's) death, the balance of the Marital Fund shall be applied pursuant to Article ___ below, but subject to the provisions of Paragraph 9 below.

5. The Trustee shall apply the Holding Fund, if any, pursuant to Paragraph 6 below (the "Oregon QTIP Fund"); provided, however, any asset or amount of the Holding Fund for which a marital deduction election for Oregon inheritance tax purposes is not made pursuant to ORS 118.010(7) and/or any applicable Oregon Administrative Rules, shall be set aside in a separate share (the "Residual Fund") and shall be applied as provided in Paragraph 7 below.

a. For purposes of the division of the Holding Fund pursuant to this Paragraph 5, if any, values assigned to all assets shall be those finally determined for federal estate tax purposes.

b. Other than in the case of specifically identified assets for which the election described above is not made, the Trustee shall have unrestricted discretion to determine what assets shall be allocated to the Residual Fund; provided, however, the Trustee shall first allocate to the Residual Fund, to the extent such assets represent a part of the Holding Fund, any asset with respect to which a marital deduction for Oregon Inheritance tax purposes is not allowable due to its character or restrictions associated with it; and further provided, however, the assets allocated to the Residual Fund shall be valued at their respective fair market values on the date or dates of each allocation.

6. The Oregon QTIP Fund set aside pursuant to Paragraph 5 above, if any, shall be applied as follows:

a. The Trustee shall pay to or for the benefit of (husband's name), during his lifetime and through the date of his death, the entire net income of the Oregon QTIP Fund. Such income shall be paid to (husband's name) at convenient intervals but not less often than quarterly. In addition, the Trustee may pay to or for (husband's name)'s benefit, such additional sums from the principal of the Oregon QTIP Fund as the Trustee, in its discretion, determines to be reasonable and necessary for (husband's name)'s health, support and maintenance.

b. If any residential real estate used by the Trustor as the Trustor's principal residence or for recreational or vacation purposes, or any interest therein or replacement thereof, is included in the Oregon QTIP Fund, then (husband's name) shall be entitled to use and occupy such property or properties for the balance of his

lifetime after the death of the Trustor without the payment of rent therefor. In all other regards the Trustee shall treat such property or properties as assets of the Oregon QTIP Fund and shall be fully responsible for their repair, maintenance and care and shall discharge all financial responsibilities associated with them.

c. Upon (husband's name)'s death, the Trustee shall apply the balance of the Oregon QTIP Fund pursuant to Article __ below, but subject to the provisions of Paragraph 9 below.

d. It is the Trustor's intent that the provisions of this Paragraph 6 cause the Oregon QTIP Fund to qualify for an "Oregon only QTIP election" within the meaning of OAR 150-118.010(7), or such other Oregon administrative rule or statute of similar effect as may hereafter be adopted, and all provisions in this Paragraph 6 shall be interpreted consistently with such intent.

7. The Residual Fund set aside pursuant to Paragraph 5 above shall be applied as follows:

a. The Trustee may pay to or for the benefit of (husband's name) during his lifetime, such sums from the income and principal of the Residual Fund as the Trustee determines, in its discretion, to be reasonable and necessary for his/her health, support and maintenance.

b. After consultation with (husband's name), if he is not incapacitated, the Trustee may pay to or for the benefit of the lineal descendants of the Trustor, or any of them, such sums from the income and principal of the Residual Fund as the Trustee determines, in its discretion, to be reasonable and necessary for the individual or collective health, support, maintenance and education. However, the Trustee's primary concern shall be for the welfare of (husband's name) and, secondarily, for the welfare of the Trustor's lineal descendants.

c. If any residential real estate used by the Trustor as the Trustor's principal residence or for recreational or vacation purposes, or any interest therein or replacement thereof, is included in the Residual Fund, then (husband's name) shall be entitled to use and occupy such property or properties for the balance of his lifetime after the death of the Trustor without the payment of rent therefor. In all other regards, the Trustee shall treat such property or properties as assets of this trust estate and shall be fully responsible for their repair, maintenance and care and shall discharge all financial responsibilities associated therewith.

d. Upon (husband's name)'s death, the balance of the Residual Fund shall be applied pursuant to Article ___ below, but subject to the provisions of Paragraph 9 below.

8. If (husband's name) is acting as the Personal Representative of the Trustor's estate or the Trustee of the trust(s) created in this 9 at the time for making the marital deduction election, if any, pursuant to Section 2056(b)(7) of the Code, such election or non-election shall not be made by (husband's name), but, instead, such election or non-election shall be made by the next successor Trustee designated pursuant to Article ___ below.

9 The Trustor hereby grants unto (husband's name), during his lifetime after the death of the Trustor, a limited power of appointment to alter the division and distribution of the Marital Fund, the Residual Fund and the Oregon QTIP Fund, if any, provided in Paragraph 6.

a. (husband's name) may change the beneficiaries of the shares so described by adding and/or deleting any lineal descendant of the Trustor and/or the spouse of any lineal descendant of the Trustor, and may alter the division of the trust estate among the beneficiaries, as presently identified or as altered, in such manner as (husband's name) shall designate, including the extension or reduction of the term of this Trust as it pertains to any share hereof and the creation of other trusts.

b. (husband's name) shall exercise the limited power of appointment herein granted after the death of the Trustor in a written instrument (other than a Will) which (i) specifically refers to this power, (ii) is acknowledged before a notary public or other person authorized to administer oaths, (iii) is filed with the Trustee during (husband's name)'s lifetime, and (iv) remains unrevoked at the time of his death. (husband's name) is not limited to one exercise of this limited power of appointment, and any exercise of this power may be revoked or modified by a subsequent written instrument (other than a Will) as described above.

D. Multi-jurisdictional property. Another problem which arises is the situation where the decedent owns property located both in Oregon and in another state, and the exemptions for estate tax purposes are different. For instance, in California, where the estate tax exemption is higher than the Oregon Exemption, the California estate may have no tax because of the higher California exemption, yet Oregon will exact a tax on the Oregon property in the California estate because of Oregon's lower exemption. This results from Oregon's apportionment rules under OAR 150-118.010(3). John Draneas, when faced with this issue, has attempted to draft language which also "cascades" different state exemptions into the credit shelter trust to take advantage of funding to the highest common denominator. The language drafted by Mr. Draneas is as follows:

Article 6
Credit Shelter Trust Share

The Credit Shelter Trust share shall be divided, held, administered and distributed as follows:

6.1 Division for State Inheritance Tax Purposes. *If, but for the provision of this Article, my estate would be subject to estate or inheritance tax in any state ("State Inheritance Tax"), the Credit Shelter Trust Share shall be divided into two separate shares as follows. One share, referred to as the "State Exempt Share," shall be equal to the largest fractional share of the Credit Shelter Trust Share that can pass free of State Inheritance Tax. The other share, referred to as the "State Taxable Share," shall include the remainder of the Credit Shelter Trust Share; however, I recognize that, due to possible similarities between Federal and State laws, the State Exempt Share may be 100% of the Credit Shelter Trust Share. The State Exempt Share shall be held, administered and distributed in a separate trust referred to as the "[*Client Last*] Credit Shelter Trust" in accordance with Section 6.5. The State Taxable Share shall be further divided in accordance with Section 6.2.*

6.2 Further Division of State Taxable Share. *I recognize that my estate may be subject to State Inheritance Tax in more than one state, and such states ("Taxable States") may have different State Inheritance Tax laws, rules and regulations such that the determination of the State Exempt Share would be different if determined under the laws, rules and regulations of the various Taxable States. I also recognize that in such circumstances, the application of Section 6.1 will result in the State Exempt Share being limited to the largest fractional share of the Credit Shelter Trust Share that can escape State Inheritance Tax in all Taxable States. In such event, in order to facilitate tax planning in the various Taxable States, the State Taxable Share shall be further divided into separate shares as follows:*

a. *Share A shall be equal to such fractional share of the State Taxable Share as would, if added to the State Exempt Share, pass free of State Inheritance Tax in the second highest number of Taxable States.*

b. *The remainder of the State Taxable Share shall be allocated to successive shares, identified as Shares B, C, etc., as can pass free of State Inheritance Tax in the third, fourth, etc. highest number of Taxable States, with the remainder of the State Taxable Share allocated to the final such share.*

*If my estate is not subject to State Inheritance Tax in more than one Taxable State, or if all Taxable States use the same rules, then the entire State Taxable Share shall be allocated to Share A. Any of the foregoing shares as to which no election described in Section 6.4 is made shall be held in a separate trust in accordance with Section 6.5. The remainder of the shares shall each be held in a separate trust in accordance with Section 6.6. Each of such separate trusts shall be referred to as the "[*Client Last*] [letter] Trust," and the entire group is referred to herein as the "[*Client Last*] Letter Trusts."*

6.3 Method of Division. *The divisions of the various shares pursuant to Sections 6.1 and 6.2 shall be made by applying the provisions of Section 5.1 by*

reference to the equivalent provisions of the relevant State Inheritance Tax laws, rules and regulations.

6.4 Tax Elections. *My Personal Representative shall be free to make elections pursuant to Section 2056 (b) of the Code, or its equivalent under the laws, rules and regulations of each of the Taxable States, as my Personal Representative deems advisable for the purpose of minimizing the aggregate State Inheritance Tax payable by my estate.*

X. <u>When to do What</u>. In analyzing the different effects of the Oregon law, we attempted to evaluate alternate scenarios to determine whether and to what extent different Oregon estate plans should be entertained given different amounts. In the schedule below, A and B are married, and each has a taxable estate of $1.5 million. Presume A dies in the year 2005, when the Oregon Exemption is $950,000 and the Federal Exemption amount is $1.5 million. The Schedule reflects the differing results of three different estate plans, depending on whether B dies in 2005, 2006 or 2009.

Facts: A and B are married with $1,500,000 each. A dies in 2005;
B dies in either 2005, 2006 or 2009.

<u>Scenario 1</u>: Winner-take-all

B dies in:	**<u>2005</u>**	**<u>2006</u>**	**<u>2009</u>**
Federal tax at A's death:	$ -0-	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-	-0-
Federal tax at B's death:	915,000	705,000	-0-
Oregon tax at B's death:	182,000	182,000	182,000
Total Taxes:	$1,097,000	$ 887,000	$ 182,000

Scenario 2: Fund to federal amount of credit

B dies in:	2005	2006	2009
Federal tax at A's death:	$ -0-	$ -0-	$ -0-
Oregon tax at A's death:	64,400	64,400	64,400
Federal tax at B's death:	-0-	-0-	-0-
Oregon tax at B's death:	64,400	64,400	64,400
Total Taxes:	$ 128,800	$ 128,800	$ 128,800

Scenario 3: Fund to Oregon exemption only (survivor's estate is $2,050,000)

B dies in:	2005	2006	2009
Federal tax at A's death:	$ -0-	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-	-0-
Federal tax at B's death:	295,500	69,000	-0-
Oregon tax at B's death:	103,200	103,200	103,200
Total Taxes:	$ 398,700	$ 172,200	$ 103,200

Scenario 4: Fund to max federal and make an Oregon QTIP for GAP amount

B dies in:	2005	2006	2009
Federal tax at A's death:	$ -0-	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-	-0-
Federal tax at B's death:	915,000	705,000	-0-
Oregon tax at B's death:	182,000	182,000	182,000
Total Taxes:	$ 1,097,000	$ 887,000	$ 182,000

1. Winner-take-all. As can be seen in the "winner take all" situation, the total taxes at B's death in all three years are significantly higher than in any other scenario.

2. Fund to the Federal Exemption. Under scenario 2, we computed the numbers assuming that the credit shelter trust would be funded to the Federal Exemption in 2005 ($1.5 million), and that the credit shelter trust does not qualify as a QTIP for Oregon purposes. As can be seen, the total taxes are substantially less, principally because after setting aside $1.5 million, there is no federal tax at the second death.

3. Fund to the Oregon Exemption. Under scenario 3, we fund the credit shelter trust only to the Oregon Exemption amount at A's death. The taxes, although less than in the winner-take-all situation, are still significantly higher than the taxes would be if we funded to the full Federal Exemption amount. However, unlike scenario 2, there is no tax payable at the first death.

4. Oregon GAP QTIP. Under scenario 4, we fund to the maximum federal amount and make an Oregon QTIP election for the GAP amount in the credit shelter trust. In this case, there is no federal tax at all at B's death, and the Oregon tax is minimized because full advantage of the Oregon Exemption was taken at the first death. In this case, clearly, funding the full federal credit shelter share with an Oregon QTIP for the GAP amount yields the least overall tax whether B dies in 2005, 2006 or 2009.

A. The $4 million plan. Compare the above analysis to the examples set forth below. In this example, A and B are married and each owns $2 million. However, presume B, who dies second, dies in 2009. Taxes are analyzed based upon different scenarios depending upon whether A dies in either 2005 or 2006.

Facts: A and B are married with $2,000,000 each. A dies in either 2005 or 2006; B dies is 2009.

Scenario 1: Winner-take-all

A dies in:	**2005**	**2006**
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-
Federal tax at B's death:	225,000	225,000
Oregon tax at B's death:	280,400	280,400
Total Taxes:	$ 505,400	$ 505,400

Scenario 2: Fund to federal credit amount

A dies in:	**2005**	**2006**
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	64,400	99,600
Federal tax at B's death:	-0-	-0-
Oregon tax at B's death:	138,800	99,600
Total Taxes:	$ 203,200	$ 199,200

Scenario 3: Fund to Oregon exemption only

A dies in:	2005	2006
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-
Federal tax at B's death:	-0-	-0-
Oregon tax at B's death:	186,400	182,000
Total Taxes:	$ 186,400	$ 182,000

Scenario 4: Fund to max federal and make an Oregon QTIP for GAP amount

A dies in:	2005	2006
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-
Federal tax at B's death:	-0-	-0-
Oregon tax at B's death:	186,400	182,000
Total Taxes:	$ 186,400	$ 182,000

1. Winner-take-all. In scenario 1, the winner take all situation, taxes are again the highest.

2. Other Scenarios. In scenario 2, in which we fund to the Federal Exemption amount, the second highest tax appears. This is because the estate is still relatively small and falls under the Federal Exemption amount, but yields Oregon tax at the first death. Scenarios 3 and 4, which deal with funding only to the Oregon Exemption amount and funding to the full federal amount with an Oregon GAP QTIP, yield the same taxes. This is because even though there is no federal tax in either A's or B's estate as set forth in scenario 2, the Oregon tax is significantly less. Based upon these computations, in a combined estate of $3 million, it makes sense to focus our funding on the Oregon Exemption rather than the Federal Exemption, if we have strong reason to believe that the surviving spouse will live at least until 2009.

B. The $6 million plan. Contrast the above situation with an identical situation, except instead A and B are married with $3 million each. In this case, since we are presuming B will die in 2009 and there is a guarantee there will be federal tax, the numbers change dramatically.

Facts: A and B are married with $3,000,000 each. A dies in either 2005 or 2006; B dies is 2009.

Scenario 1: Winner-take-all

A dies in:	2005	2006
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-
Federal tax at B's death:	2,580,800	2,580,800
Oregon tax at B's death:	510,800	510,800
Total Taxes:	$ 3,091,600	$ 3,091,600

Scenario 2: Fund to federal credit amount

A dies in:	2005	2006
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	64,400	99,600
Federal tax at B's death:	1,905,800	1,680,800
Oregon tax at B's death:	335,600	280,400
Total Taxes:	$ 2,305,800	$ 2,060,800

Scenario 3: Fund to Oregon exemption only

A dies in:	2005	2006
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-
Federal tax at B's death:	2,153,300	2,130,800
Oregon tax at B's death:	397,200	391,600
Total Taxes:	$ 2,550,500	$ 2,522,400

Scenario 4: Fund to max federal and make an Oregon QTIP for GAP amount

A dies in:	2005	2006
Federal tax at A's death:	$ -0-	$ -0-
Oregon tax at A's death:	-0-	-0-
Federal tax at B's death:	1,905,800	1,680,800
Oregon tax at B's death:	397,200	391,600
Total Taxes:	$ 2,303,000	$ 2,072,400

1. Winner-take-all. In the winner take all scenario, the total taxes are still clearly the highest.

2. Funding to the Federal Exemption. An interesting result entails, however, if we fund to the full Federal Exemption amount in scenario 2. As will be seen below, if A dies in 2005, the total taxes are still higher than funding to the maximum Federal Exemption and making an Oregon QTIP election for the GAP amount. However, if A dies in 2006, so that the initial credit shelter trust is funded with $2 million rather than $1.5 million, the actual total tax after B's death in 2009 is the least of any of the scenarios. Presumably, this is because even though additional OTax was paid at A's death in 2006, the difference is at a rate of 7.2%, whereas waiting until 2009 to pay the tax causes the $500,000 increment to be taxed at an 11.2% Oregon rate, yielding substantially higher OTax. What is not taken into consideration in this analysis, however, is the time value of money.

3. Funding to the Oregon Exemption. In each of the scenarios, it is clear that funding only to the Oregon Exemption yields an unnecessarily high amount of tax.

4. The Oregon GAP QTIP. Scenario 4, in which we fund to the maximum Federal Exemption and make an Oregon QTIP election on the GAP amount, will work better or worse than funding strictly to the Federal Exemption amount and not making a GAP QTIP election, depending upon the year of death of the first spouse and the year of death of the second spouse. Since it will always be difficult or impossible to ascertain which spouse will die first and in what year they will die, it is reasonable to presume that funding to the maximum Federal Exemption amount and electing QTIP for the GAP portion will still yield the safest result, especially given the distaste for having to pay significant Oregon inheritance taxes at the first death.

XI. Let's Put it all in Perspective.

A. Remember who pays the tax. Given all the changes discussed above, the news is not totally bad. Remember, only 2% of all estates nationally, only those who are the wealthiest people in America, face any estate tax liability. Having a net worth less than the minimum amount necessary to trigger estate taxes, somewhere between $675,000 and $1.5 million depending upon the state of domicile, accounts for 98% of America. Of those 2% who are paying estate taxes, the net amount they pay because of EGTRRA will be substantially less than they would have paid had EGTRRA not been passed.[12] It is also important to note that people living in certain states will pay more state inheritance tax than those in other states. This is not because those states have increased their inheritance tax, it is instead because the federal government has reduced its State Death Tax Credit and those states have elected not to assume the burden of that reduction.

[12] McNichol, Elizabeth C. "Assessing the impact of estate taxes" Center on Budget and Policy Priorities, February 18, 2004.

B. Residency changes. Our legislature is faced with the strong possibility that many of the wealthiest citizens of Oregon will attempt to change their domicile to a jurisdiction with more favorable inheritance tax rates. In our practices, we have already seen a number of our clients who have taken up permanent residence in more tax-friendly states, while maintaining "vacation" homes in the state of Oregon. Many of those people have committed to spending 185 days per year in the state of domicile, while spending the rest of the time in Oregon. By transferring their assets to revocable living trusts which are deemed to be non-Oregon situs trusts, those people are avoiding OTax. It goes without saying that a number of Oregon's very wealthy residents have elected to move because of the impact of the new OTax. Whether and to what extent this will have a profound effect upon our state's economy will only be determined with the passage of time.

C. Most Oregonians like it here. Even with the above considerations in mind, studies continue to show that most people choose their residence based upon proximity to employment and family members, climate and access to state services, and other lifestyle issues. Very few people choose a state of residence because of its inheritance tax structure. It is unlikely that state inheritance tax changes will significantly change these ideologies. In fact, the argument can be made that states which have elected to retain a state inheritance tax will have more money to provide basic services and infrastructure, which may make the state even more attractive for retaining its high net worth residents. This argument, however, is tenuous at best. The argument can also be made that the retention of state inheritance tax could also avoid raising other taxes, such as an Oregon sales tax.

D. Some other observations. Even though the OTax is now subject to a top marginal rate of 16%, that rate only applies to the portion of the estate that exceeds $10 million. The vast majority of all estates, even those large enough to pay estate tax, is still well under $10 million. Currently, only 2.6% of those estates actually paying estate tax, representing a scant 52 taxpayers out of every 100,000, have estates in excess of $10 million. In those estates, since the IRC §2011 credit is being replaced with a deduction, the marginal inheritance tax rate will actually be less than 16%. Since the OTax is deductible on the federal return and the top federal rate is 45%, the effective top marginal OTax rate is only 8.8%. Approximately 83% of the estates owing estate tax are valued at less than $2.5 million. These estates will have OTax of no more than 3-5%, which may or may not be a significant incentive to move.[13] The effect of the estate tax, therefore, is only borne by a very, very small fraction of families in America. In the year 2001, the Internal Revenue Service compiled numbers based upon returns filed. These numbers reflected the following information:

[13] McNichol supra.

Size of Estate	**Number of Returns Filed**	**Percentage of Returns Filed**
$625,000-$1,000,000	18,198	35.1%
$1,000,000 - $2,500,000	24,591	47.4%
$2,500,000 - $5,000,000	5,551	10.7%
$5,000,000 - $10,000,000	2,165	4.2%
$10,000,000 - $20,000,000	868	1.7%
$20,000,000 or more	469	0.9%
TOTAL	51,842	100%

EXHIBITS

1. **HB 3072**
2. **Inheritance Tax Advisory (5-24-04)**
3. **2004 Form IT-1 and Instructions**
4. **OAR 150-118.010(2)**
5. **OAR 150-118.010(7)**
6. **OAR 150-316.272**
7. **Legislative Proposal LC470 (ORS 118.022 Oregon Special Marital Property)**
8. **Sample Letter to Clients**
9. **Revenue Ruling Request**

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Estate Planning Council of Portland
Annual Seminar
Janury 21, 2005

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***The authors wish to acknowledge the contributions of many professionals who have contributed to the legislation through the Inheritance Tax Work Group that is sponsored by the Oregon State Bar including, but not limited to, Anne Thompson, Jim Cavanaugh, Judy Killian, Katherine Van Zanten, Kay Wakefield, Mark L. Huglin, Mike Gleeson, Steve Kantor, Steve Lane, Ron Bailey, Tom Jones, and Susan Grabe. We also wish to acknowledge the excellent work of Jeff Cheyne whose outline from a previous presentation served as a useful focus for this presentation.

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Table of Contents

Table of Contents (continued)

Table of Contents (continued)

Exhibits