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Research Brief

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Oregon's Inheritance Tax

The Federal Estate Tax and the Pick-up Tax

Oregon taxpayers do not currently pay estate or inheritance taxes to Oregon in addition to their federal estate tax liability. Rather Oregon tax liability is tied to the federal estate tax, especially the "state death tax credit".¹ Oregon, like all the other states, uses the federal state death tax credit as a "pick-up" tax, collecting the maximum amount allowed under federal law as a credit against the federal estate tax, and no more.²

A state death tax credit is allowed against the federal estate tax for any estate, inheritance, legacy, or succession taxes paid to any state or the District of Columbia. The maximum credit allowable is determined by a graduated rate table based on the size of the decedent's taxable estate. A pick-up tax applies when the state-imposed death tax liability is less than the maximum death tax credit. In such cases the pick-up tax imposed by the state is equal to the difference between the state death tax liability and the maximum death tax credit. A pick-up tax does not affect the taxpayer's total (federal plus state) tax liability, while providing the state with the maximum amount of tax revenue allowable as a state death tax credit.

Recent legislation made fundamental changes to the federal tax system. In addition to cutting the personal income tax, P.L. 107-16 (The Economic Growth And Tax Relief Reconciliation Act of 2001) also reduces the federal estate tax over a nine year period by gradually cutting tax rates and increasing the exemption amount (the "unified credit"). Under P.L. 107-16 the phase-out is complete and the federal estate tax is completely repealed in 2010, however for budgetary reasons it reverts back to its current form in 2011. In order to mitigate the revenue impact, P.L. 107-16 also phases-out the state death tax credit, reducing it by 25% in 2002, 50% in 2003, 75% in 2004, and repealing it entirely beginning 2005.

History of Oregon Inheritance Taxes

Until 1987 Oregon levied its own state inheritance tax. Prior to 1978 the Oregon inheritance tax was calculated as a variable percentage of taxable estate value. The tax varied with the amount of the transfer and the relationship of the beneficiary to the decedent. The tax rate for an inheritance by a grandparent, parent, spouse or child ranged up to 12% for inherited amounts exceeding \$500,000. Tax rates were higher, ranging up to 20%, for inheritances by a brother, sister, aunt, uncle, niece, nephew, son-in-law or daughter-in-law. The rates for transfers to unrelated persons were higher still, up to 25%. A credit up to \$300,000 was allowed for inheritances by a surviving spouse and minor or disabled child. Additionally, if the amount of the

¹ The term "death tax" is used to refer to any tax that is imposed at the time of the death of an individual. This includes inheritance taxes and estate taxes. An "inheritance" tax is a tax on the right to receive property at death from an individual and generally is measured by the amount that a particular legatee receives from the decedent. An "estate" tax is a tax on the right to transfer property at death and generally is measured by the total amount passing at the time of the decedent's death. Historically, inheritance taxes were imposed by States, while estate taxes were imposed by the Federal Government.

² All 50 states collect inheritance or estate taxes. Thirty five (35) states currently use only the pick-up tax. The rest use the pick-up tax in combination with a state death tax. Connecticut and Louisiana are phasing out their inheritance taxes.

Oregon tax was less than the maximum state death tax credit allowed by federal law, then the difference was added to the state tax liability and collected as a pick-up tax.

The 1977 Legislature simplified and enacted gradual repeal of the Oregon inheritance tax. The new tax rate was fixed at a flat 12% of net taxable estate value for all beneficiaries. The legislation gradually increased the exemption amount while reducing the credit. The combined effect of these changes was to maintain at least \$500,000 in tax-free inheritance by a spouse, minor child or disabled child. As before, a pick-up tax was collected based on the difference between the Oregon inheritance tax and state death tax credit.

Beginning January 1, 1987 the statutory inheritance tax rate became zero, and the system reverted to its current form with only the pick-up tax remaining.

Oregon Inheritance Tax and Connection to Federal Law

Oregon does not automatically connect to changes in the federal estate tax as it does to changes in taxable income.³ The Oregon pick-up tax law is currently tied to the federal state death tax credit as it was defined in 1997, the last time the relevant Oregon statute was modified.⁴

Thus Oregon inheritance taxes will not automatically decline with the changes in the federal estate tax under P.L. 107-16. While taxpayers' federal estate tax will be reduced, their Oregon liability may not as it is determined by the 1997 definition of the state death tax credit. Also since the amount of the state death tax credit recognized under federal law is phasing out, taxpayers will no longer get full credit for Oregon inheritance taxes paid against their federal tax liability.

This issue is complicated by the federal unified credit which acts as an exemption or zero bracket amount, effectively creating a value threshold for taxable estates. Changes in the unified credit since 1997 have gradually increased this threshold, thereby excluding an increasing number of individuals from having to pay the federal estate tax. If Oregon were truly "frozen" to the 1997 federal estate tax, then everyone liable under the 1997 definition of the unified credit should currently pay Oregon estate taxes, whether or not they had federal tax liability. However Oregon has collected inheritance taxes only from those individuals filing and paying federal estate tax. By not requiring those falling between the 1997 federal taxability threshold and the current threshold to file and pay Oregon estate tax, Oregon seems to have effectively "connected" to the changes in the federal unified credit.

Implications

Approximately \$90 million in Oregon inheritance tax is collected each biennium. All of this is General Fund revenue. If Oregon chooses to adopt the spirit of the changes in P.L. 107-16 and phase-out its inheritance tax, then General Fund revenue will be reduced by about \$22 million in the current biennium (2001-03), \$66 million in 2003-05 and \$90 million in 2005-07.

If Oregon chooses to enact its own inheritance tax, or to hold to a prior version of the disappearing federal state death tax credit, then this will start costing Oregon taxpayers real dollars, not simply dollars that would otherwise have gone to the federal government.

The phase-out of the federal estate tax exerts pressure on the Legislature to either ratify the federal changes in P.L. 107-16 and update Oregon's pick-up tax, or else enact a separate and distinct Oregon inheritance tax as was the case until 1987. This issue needs to be addressed by the 2003 Legislature.

³ See June 6, 2001 opinion from Legislative Counsel. Under current law Oregon generally connects to changes in federal taxable income but not to changes in tax credits or other aspects of the federal income tax system.

⁴ See ORS 118.010 (2).