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THE OKLAHOMA ESTATE TAX: MODEST PROPOSALS FOR CHANGE

MARK R. GILLETT*

I. Introduction

Since 1976, Congress has amended the estate, gift, and generation-skipping transfer tax provisions in the Internal Revenue Code on at least twenty occasions.¹ Although some of these revisions were inconsequential,² others have had significant impact on the estate planning practice.

As originally enacted, the Oklahoma estate tax generally paralleled the federal provisions. However, during that same period of time, the Oklahoma legislature

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1. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 416; Energy Policy Act of 1992, Pub. L. No. 102-486, 106 Stat. 2776; Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, §§ 11101-11901, 104 Stat. 1388, 1388-400 to -561; Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, 2301; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342; Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330; Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085; Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494; Indian Tribal Governmental Tax Status Act of 1982, Pub. L. No. 97-473, 96 Stat. 2605 (1983); Technical Corrections Act of 1982, Pub. L. No. 97-448, 96 Stat. 2365 (1983); Act of Sept. 17, 1982, Pub. L. No. 97-258, 96 Stat. 877; Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172; Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, 94 Stat. 3521; Foreign Service Act of 1980, Pub. L. No. 96-465, 94 Stat. 2071; Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229; Technical Corrections Act of 1979, Pub. L. No. 96-222, 94 Stat. 194 (1980); Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763; Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, 91 Stat. 126; Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520.

2. *E.g.*, Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 301, 94 Stat. 3521, 3530-31 (amending I.R.C. § 2055(e) to grant additional time to reform split-interest charitable trusts); Act of Sept. 13, 1992, Pub. L. No. 97-258, § 9702(3)(f)(2), 96 Stat. 877, 1064 (conforming the cross reference currently found in I.R.C. § 2055(g)(7)).

has amended the substantive estate tax provisions on only five occasions.³ In 1981, the legislature reduced the tax rates for taxable estates less than \$250,000⁴ and increased the exemption for property passing to the decedent's parents and descendants⁵ from \$60,000 to \$175,000.⁶ Recently, the legislature granted an additional \$425,000 exemption for qualified family businesses and farms passing to the decedent's parents and descendants.⁷ The three other changes were insignificant.⁸

It is not necessary for Oklahoma to embrace every federal change. In fact, Congress often enacts a sweeping reform only to later reverse its decision.⁹ However, the legislature's failure over the past two decades to incorporate pertinent federal changes has resulted in major differences between the two taxing systems.

The purpose of this article is to analyze those disparities, which will alert practitioners to their estate planning consequences and will demonstrate the need to overhaul the Oklahoma estate tax. The article will then propose two diverse legislative responses.

3. This should be compared with the six amendments to the provision which sets forth the procedure by which financial institutions can release the decedent's assets to the beneficiaries or the estate. *See* 68 OKLA. STAT. § 812 (amended by Act of June 12, 1996, ch. 334, § 4, 1996 Okla. Sess. Law Serv. 1533, 1535 (West); Act of Apr. 26, 1993, ch. 110, 1993 Okla. Sess. Laws 288; Act of May 26, 1992, ch. 295, § 9, 1992 Okla. Sess. Laws 1199, 1213-14; Act of May 25, 1984, ch. 231, § 4, 1984 Okla. Sess. Laws 846, 848-49; Act of May 10, 1980, ch. 202, 1980 Okla. Sess. Laws 448; Act of May 15, 1979, ch. 173, § 12, 1979 Okla. Sess. Laws 425, 441).

4. Act of June 22, 1981, ch. 237, § 1, 1981 Okla. Sess. Laws 566, 566-68 (amending 68 OKLA. STAT. § 803 (Supp. 1930)). If property passed to parents or descendants, this resulted in a potential savings of \$6350, and for other beneficiaries, a potential savings of \$3700. The legislature also rewrote title 68, section 804, but made no substantive changes. *See id.* § 2, 1981 Okla. Sess. Laws at 568.

5. The exemption is available for property passing to "the father, mother, child, child of husband or wife, adopted child or any lineal descendant of decedent or of such adopted child." 68 OKLA. STAT. § 809(A) (Supp. 1996). This same group is entitled to the lower tax rates set forth in section 803(1) of title 68. This article will reference these individuals as the decedent's parents and descendants even though the classification is broader.

6. Act of June 22, 1981, § 3, 1981 Okla. Sess. Laws 566, 568 (amending 68 OKLA. STAT. § 809 (Supp. 1980)).

7. Act of June 12, 1996, ch. 334, § 3, 1996 Okla. Sess. Law Serv. 1533, 1534 (West) (amending 68 OKLA. STAT. § 805 (1991)). *See infra* notes 61-88 and accompanying text.

8. The 1989 amendment required nonresident decedents to include in the value of the Oklahoma gross estate a partnership interest if its business is conducted in Oklahoma or the majority of its assets are located in Oklahoma. *See* Act of May 19, 1989, ch. 249, § 18, 1989 Okla. Sess. Laws 711, 732-35 (amending 68 OKLA. STAT. § 807 (1981)). The 1988 amendment permitted estates to deduct as an administration expense auction fees, abstract costs, and documentary stamps purchased for recording deeds. *See* Act of July 1, 1988, ch. 312, § 1, 1988 Okla. Sess. Laws 1571, 1571-72 (amending 68 OKLA. STAT. § 808 (1981)). The 1977 amendment authorized nonresident decedents dying during the period of February 4, 1975, and June 17, 1976, to exclude transfers to the surviving spouse. *See* Act of May 27, 1977, ch. 110, 1977 Okla. Sess. Laws 324 (adding 68 OKLA. STAT. § 826).

9. *See infra* note 243 and accompanying text.

II. Comparing the Federal and Oklahoma Estate Taxes

Although the Oklahoma estate tax is modeled after the federal, there are virtually no provisions which remain the same as their federal counterparts. For example, Oklahoma includes in the gross estate property with respect to which the decedent has made a transfer, retaining the future income. The pertinent language is as follows:

§ 807. Value of gross estate—Terms defined—Property not specifically devised—Exempt estates

(A) The value of the gross estate, used as a basis for a determination of the value of the net estate, shall be determined by including:

....

(3) To the extent of any interest therein of which the decedent has, at any time, made a transfer, in trust or otherwise, . . . where the decedent reserved to himself during his life the income from the property included in any such transfer¹⁰

This language has remained basically unchanged from its original enactment in 1935.¹¹

At that time, the corresponding federal provision relating to transfers in which the decedent retained a life estate provided as follows:

Sec. 811. Gross Estate.

The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property . . .

(c) To the extent of any interest therein . . . of which [the decedent] has at any time made a transfer, by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession of enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefore; except in case of a bona fide sale for an adequate and full consideration in money or money's worth.¹²

10. 68 OKLA. STAT. § 807(a)(3) (1991).

11. See Act of Apr. 23, 1935, ch. 66, art. 5, § 2, 1935 Okla. Sess. Laws 274, 274-75. Prior to 1935, Oklahoma had an inheritance tax which was not modeled after the federal estate tax. See 66 OKLA. STAT. §§ 12469-12497 (1931).

12. See Revenue Act of 1932, Pub. L. No. 154, 47 Stat. 169, 279. This amendment followed a flurry of judicial and legislative action involving retained life estates. For a discussion of the history of I.R.C. § 2036, see RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 4.08[10] (6th ed. 1991). Current I.R.C. § 2036(a) closely resembles the 1935 version:

Sec. 2036. Transfers with Retained Life Estate.

It is apparent that the federal provision casts a broader net. For example, assume that a person establishes a trust, retaining only the right to determine which of two children will receive the trust's income. Although this demonstrates substantially less ownership attributes than the beneficial retention of the income, Congress has determined that the trust should be included in the decedent's gross estate, valued as of the date of death.¹³ However, the trust clearly falls outside the scope of the Oklahoma provision which requires that the decedent retain the income from the transferred property.

Due to the dearth of legislative history, it is impossible to determine why the Oklahoma legislature decided to tax transfers only if decedents retain a beneficial interest in the property conveyed during their lives.¹⁴ Even though this example may represent a conscious decision on its part, there are many other examples of the Oklahoma estate tax being more munificent than its federal counterpart.¹⁵

These incongruities do not pose serious problems to practitioners since the Internal Revenue Code generally dictates estate planning decisions. Attorneys will

(a) General Rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) The possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

I.R.C. § 2036 (1994). In 1978, Congress added a provision which treats the retention of voting rights in a controlled corporation as retention of the enjoyment of the transferred property. *See* Revenue Act of 1978, Pub. L. No. 95-600, § 702(i), 92 Stat. 2763, 2931 (amending I.R.C. § 2036(b)). Oklahoma has not incorporated this change.

13. The decedent's discretion to distribute income between two named individuals is sufficient to result in the trust's inclusion in the gross estate. *See* I.R.C. § 2036(a)(2) (1994); *Industrial Trust Co. v. Commissioner*, 165 F.2d 142, 146 (1st Cir. 1947).

14. Compare title 68, section 807(A)(3) of the Oklahoma Statutes, which includes in the Oklahoma gross estate the value of a trust to which the decedent made a transfer and retained the power to amend the trust, even though that power may not necessarily be exercisable in the decedent's favor. It is more likely that the legislature failed to sufficiently consider the differences between its bill and the federal statute.

15. Compare, e.g., I.R.C. § 2041 (providing that jointly held general powers of appointment result in the appointive property being included in the decedent's gross estate unless an express exception is satisfied) with 68 OKLA. STAT. § 807(A)(9) (omitting such provision); compare I.R.C. § 2042(2) (treating certain reversionary interests in life insurance policies as incidences of ownership) with 68 OKLA. STAT. § 807(A)(5), (6) (omitting such provision); compare I.R.C. § 2039 (including all annuities within the scope of the statute in the gross estate) with 68 OKLA. STAT. 807(A)(6)(d) (excluding certain annuities); compare Treas. Reg. § 20.2031-8(a) (as amended in 1974) (including all insurance owned by the decedent on the life of another in the gross estate) with 68 OKLA. STAT. § 807(A)(6)(b) (excluding insurance on the life of another if the beneficiary paid the premiums); compare Rev. Rul. 69-489, 1969-2 C.B. 172 (including certain United States Treasury bonds (flower bonds) in the gross estate at par value if they could have been used in payment of estate tax) with 68 OKLA. STAT. § 816.1 (including such bonds at par value only if they were used to pay federal estate tax).

advise their clients against retaining powers over the income of an irrevocable trust to avoid the application of section 2036. Therefore, the fact that Oklahoma permits individuals to retain the ability to direct who will receive the income without adverse state death tax consequences normally is irrelevant in a planning context.¹⁶

Planners are concerned, however, when valid federal estate planning strategies have adverse effects for Oklahoma estate tax purposes, when state laws are more restrictive than their federal counterparts, and when state law is ambiguous. These are the areas which the Oklahoma legislature should address.

A. *Qualified Terminable Interest Property*

In 1948, Congress created a deduction for property passing to the surviving spouse to the extent that it did not exceed 50% of the adjusted gross estate.¹⁷ In 1976, Congress increased the deductible amount to the greater of 50% of the adjusted gross estate or \$250,000.¹⁸ Five years later, Congress amended section 2056 to provide for an unlimited marital deduction.¹⁹ At that same time, Congress authorized a marital deduction for qualified terminable interest property (QTIP).²⁰

A marital deduction generally is disallowed if the interest passing to the surviving spouse terminates or fails on the occurrence of an event or contingency, if an interest in such property passed from the decedent to a person other than the surviving spouse, and if that person may possess or enjoy the property after the termination of the spouse's interest.²¹ Prior to 1981, section 2056(b)(5) provided

16. These variances do have consequences to the state fisc. It is impossible to estimate the revenue loss which Oklahoma incurs as the result of its more lenient estate tax provisions.

17. Revenue Act of 1948, Pub. L. No. 471, § 361, 62 Stat. 110, 117-21. The reasons were succinctly stated in *United States v. Stapp*, 375 U.S. 118 (1963):

The 1948 tax amendments were intended to equalize the effect of the estate taxes in community property and common-law jurisdictions. Under a community property system, such as that in Texas, the spouse receives outright ownership of one-half of the community property and only the other one-half is included in the decedent's estate. To equalize the incidence of progressively scaled estate taxes and to adhere to the patterns of the law, the marital deduction permits a deceased spouse, subject to certain requirements, to transfer free of taxes one-half of the non-community property to the surviving spouse.

Stapp, 375 U.S. at 128 (footnotes omitted). For excellent discussions of the history of the marital deduction, see *Estate of Clayton v. Commissioner*, 976 F.2d 1486, 1490-93 (5th Cir. 1992); Marie Landroche, *The Qualified Terminable Interest Rule: An Overview*, 34 FLA. L. REV. 737, 737-46 (1982).

18. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2002, 90 Stat. 1520, 1854.

19. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(a), 95 Stat. 172, 301. According to the legislative history, Congress believed, "that a husband and wife should be treated as one economic unit for purposes of estate and gift taxes, as they generally are for income tax purposes. Accordingly, no tax should be imposed on transfers between a husband and wife." S. REP. NO. 97-144, at 127 (1981), reprinted in 1981-2 C.B. 412, 461. In addition, Congress concluded that an unlimited marital deduction would result in substantial simplification of estate and gift taxes. H.R. REP. NO. 97-201, at 159 (1981), reprinted in 1981-2 C.B. 352, 377.

20. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(d), 95 Stat. 172, 302-05.

21. I.R.C. § 2056(b)(1) (1994).

an exception to the terminable interest rule with respect to certain trusts in which the surviving spouse received an income interest for life and over which the surviving spouse possessed a power, exercisable alone and in all events, to appoint the trust assets to herself or her estate.²² Thus, the trust is included in the surviving spouse's estate at death,²³ and the surviving spouse can control the ultimate disposition of the trust assets.

The QTIP provision added in 1981 authorizes an executor to elect to deduct the value of property passing to a trust which satisfies the requirements of section 2056(b)(7). Both sections 2056(b)(5) and (b)(7) require that the spouse receive the trust income for life.²⁴ However, the surviving spouse does not have to be granted a power to appoint a QTIP trust, and, as a result, the decedent can control the disposition of the assets on the surviving spouse's death. The committee reports included the stated reason for this liberalization of the marital deduction:

[T]he committee believes that the present limitations on the nature of interests qualifying for the marital deduction should be liberalized to permit certain transfers of terminable interests to qualify for the marital deduction. Under present law, the marital deduction is available only with respect to property passing outright to the spouse or in specified forms which give the spouse control over the transferred property. Because the surviving spouse must be given control over the property, the decedent cannot insure that the spouse will subsequently pass the property to his children. Because the maximum marital deduction is limited under present law to one-half of the decedent's adjusted gross estate, a decedent may at least control disposition of one-half of his estate and still maximize current tax benefits. However, unless certain interests which do not grant the spouse total control are eligible for the unlimited marital deduction, a decedent would be forced to choose between surrendering control of the entire estate to avoid imposition of estate tax at his death or reducing his tax benefits at his death to insure inheritance by the children. The committee believes that the tax laws should be neutral and that tax consequences should not control an individual's disposition of property.²⁵

22. *Id.* § 2056(b)(5). There were two other exceptions to the terminable interest rule. *See id.* § 2056(b)(3) (authorizing a marital deduction for interests passing to the spouse which are conditioned on surviving for a limited period); *id.* § 2056(b)(6) (authorizing a marital deduction for certain life insurance or annuity payments where the surviving spouse possesses a general power of appointment).

23. *Id.* § 2041(a).

24. *Id.* § 2056(b)(5), (7)(B)(ii).

25. H.R. REP. NO. 97-201, at 159-60 (1981), *reprinted in* 1981-2 C.B. 352, 377-78. Other commentators sense that the male dominated Congress might have had ulterior motives:

The 1948 version of the marital deduction provided a tax incentive to the donor spouse to give the surviving spouse support and an ownership share of the decedent's spouse's property (even though complete control of that share could be postponed until the surviving spouse's death). The current marital deduction requires only that the donor

If the executor makes a QTIP election, the property subject to the election is included in the spouse's estate to preserve the integrity of the federal estate tax.²⁶ The net effect, therefore, is to postpone the taxation of the marital assets until the surviving spouse's death.²⁷

Prior to 1975, transfers to the decedent's spouse were subject to the Oklahoma estate tax.²⁸ However, there was a \$60,000 exemption for transfers to the decedent's spouse, parents, and descendants.²⁹ In 1975, twenty-seven years after the enactment of the federal marital deduction and six years before the unlimited federal marital deduction, the Oklahoma legislature amended section 807 to exclude from the Oklahoma gross estate the value of all interests passing to the surviving spouse.³⁰ However, the provision included the following exception:

(3) Property or any interest therein passing to a surviving spouse must pass to such spouse as beneficial owner to qualify for this deduction and such deduction shall not apply to any nondeductible terminable interest as defined in Section 2056(b) of the Internal Revenue Code of 1954, as amended, and the regulations thereunder.³¹

As drafted, the provision clearly authorized excluding from the Oklahoma gross estate all terminable interests which qualified for the federal marital deduction.³² However, since the above provision predated the advent of QTIP trusts, no exclusion was allowed for the transfer of only a life estate to the surviving spouse at the time of the enactment.

The following year, the legislature amended the provision to eliminate the above limitation.³³ The obvious legislative intent was to allow an estate to

spouse give his surviving spouse support for life to avoid transfer taxation. Thus, viewed through the precise eye of the marital deduction provisions only, the housewife (or the spouse with lower earnings) appears further now than before from being treated as well as her counterpart in community property states - as deserving a share of outright ownership in recognition of her contribution to the economic gains of marriage.

JESSE DUKEMINIER & STANLEY M. JOHANSON, WILLS, TRUSTS, AND ESTATES 490 (5th ed. 1995).

26. I.R.C. § 2044 (1994). *But see* Estate of Shelfer v. Commissioner, 103 T.C. 10, 13-17 (1994) (holding that a trust was not included in the surviving spouse's estate since it did not satisfy the requirements of I.R.C. § 2056(b)(7) even though a marital deduction was incorrectly allowed in the first spouse's estate), *rev'd on other grounds*, 86 F.3d 1045 (11th Cir. 1996). No election is required to deduct the value of property passing to a general power of appointment trust which satisfies the requirements of I.R.C. § 2056(b)(5).

27. If the surviving spouse disposes of her income interest during life, the spouse must report as a taxable gift the full value of property subject to the QTIP election. I.R.C. §§ 2511(a), 2519(a).

28. 68 OKLA. STAT. §§ 807-808 (1971).

29. *Id.* § 809.

30. Act of Feb. 4, 1975, ch. 1, § 2, 1975 Okla. Sess. Laws 1, 3-6.

31. *Id.* § 2, 1975 Okla. Sess. Laws at 6.

32. This would include general power of appointment trusts. *See supra* notes 22-23 and accompanying text.

33. Act of June 17, 1976, ch. 266, § 1, 1976 Okla. Sess. Laws 512, 515. This was the last amendment to section 807(B) which currently reads as follows:

exclude the value of a life estate passing to the surviving spouse.³⁴ However, there has never been a corresponding amendment to require the inclusion of any portion of the trust in the surviving spouse's estate.³⁵ As a result, couples can pass property to descendants without paying Oklahoma estate tax in either of their estates.³⁶ This anomaly, combined with the Oklahoma unlimited marital exclusion, granted Oklahoma decedents dying between 1976 and 1981 more favorable tax treatment with respect to property passing to the surviving spouse than the federal counterpart.³⁷

Since 1981, QTIP trusts have become the prevalent estate planning device for two primary reasons.³⁸ Unlike general power of appointment trusts, the decedent can control the disposition of the trust assets on the surviving spouse's death. In addition, the QTIP provisions are elective rather than mandatory,³⁹ which permits the executor to postpone the decision to claim a marital deduction with respect to all or a portion of the trust until after the decedent's death.⁴⁰

(B) In determining the value of the gross estate under this section, there shall be excluded:

(1) The value of any interest in decedent's estate, beneficial or otherwise, vesting in the surviving spouse, provided that the value of such interest shall be included for the purpose of computing additional tax liability under Section 804 of this title.

(2) Such exclusion under Section 807(b)(1) shall be limited to that value of the gross estate, beneficial or otherwise, vesting in the surviving spouse, less debts, mortgages, liens, administration charges or other encumbrances chargeable against the value of the gross estate so vested.

68 OKLA. STAT. § 807(B) (1991).

34. See W. Thomas Coffman, *Current Developments — Probate Law*, 47 OKLA. B.J. 2773, 2774 (1976).

35. If the decedent possesses only an income interest in a trust established by a third person, no portion of the trust is included in the Oklahoma gross estate since the interest terminates on death. See 1 W. THOMAS COFFMAN & C. ROBERT JONES, *OKLAHOMA ESTATE PLANNING, WILL DRAFTING AND ESTATE ADMINISTRATION FORMS*, § 12.2.3 (1994). However, if the decedent grants the surviving spouse an income interest coupled with a general power of appointment, the full value of the trust is included in the spouse's estate for Oklahoma tax purposes. See 68 OKLA. STAT. § 807(A)(9) (1991). Under the federal rules, the allowance of a marital deduction in the first estate always results in the inclusion of the property in the survivor's estate. See *supra* notes 26-27 and accompanying text.

36. Assume that the decedent transfers \$1,000,000 to a testamentary trust which directs the trustee to pay income to the surviving spouse for life and, on her death, to distribute the remainder to their children. If the surviving spouse is 60 years old at the decedent's death, the estate can exclude \$447,464 which is the value of the survivor's income interest. See OKLAHOMA TAX COMM'N, *OKLAHOMA ESTATE TAX LAW* 40 (1994). That portion of the trust escapes taxation in both estates since no portion is included in the survivor's estate.

37. Prior to the enactment of I.R.C. § 2056(b)(7), the transfer of a life estate to the surviving spouse did not qualify for the federal marital deduction. Since the Internal Revenue Code controls most estate planning decisions, this opportunity to avoid Oklahoma estate tax was of little practical value.

38. See JOHN R. PRICE, *PRICE ON CONTEMPORARY ESTATE PLANNING* § 5.26 (1992). In addition, the estate can make a reverse QTIP election to allocate a portion of the decedent's GST exemption to a QTIP trust. See I.R.C. § 2652(a)(3) (1994). This election is not available with respect to general power of appointment trusts and permits the estate to fully utilize the decedent's exemption to insulate a QTIP trust from the future imposition of GST tax.

39. I.R.C. § 2056(b)(7)(B)(i)(III).

40. The code authorizes partial elections only if expressed as a fraction or percentage of the entire

Oklahoma's failure to enact a QTIP provision generally results in more tax being due on the first spouse's death and less tax on the surviving spouse's death since only the actuarial value of the life estate is excluded from the first estate, and no portion of the trust is included in the second estate. In some instances, these effects are more consequential. This is best demonstrated by a rare, yet catastrophic, example. Assume that an Oklahoma resident died in 1996 with a \$15,000,000 estate. His will established a trust which grants his seventy-year-old surviving spouse a qualifying income interest for life and transfers to that trust the smallest amount which, if allowed as a federal estate tax marital deduction, will result in the least possible federal estate tax. The remainder of his estate (less any federal and state taxes) passes outright to the children. Even if the executor makes an effective QTIP election, the transfer results in the imposition of Oklahoma estate tax in excess of the amount sheltered by the federal unified credit.⁴¹ The resulting federal estate tax further reduces the available marital deduction, compounding the problem.⁴² The interrelated computation ultimately results in the payment of \$132,748 of federal and \$903,828 of Oklahoma estate tax.⁴³

In this case, it is inaccurate to conclude that this merely accelerates the payment of the tax to the husband's death. Assuming that the spouse has no other assets, nothing will be included in her Oklahoma gross estate when she dies.⁴⁴ However, Oklahoma imposes an additional tax to absorb the federal credit for state death taxes,⁴⁵ and the QTIP trust is included in her gross estate for federal estate tax purposes.⁴⁶ Assuming that the trust assets neither increase nor decrease in value, the available federal credit for state death taxes is \$1,700,948,⁴⁷ which must be paid to the state of Oklahoma.⁴⁸ As a result, Oklahoma imposes a total

trust. *See id.* § 2056(b)(7)(B)(iv), (b)(10).

41. The estate receives a credit equal to \$192,800 which shelters a \$600,000 taxable estate. *See id.* §§ 2001(c), 2010(a).

42. The marital deduction is reduced by the amount of taxes and other expenses payable out of assets passing to the surviving spouse. *See id.* § 2056(b)(4); Treas. Reg. § 20.2056(b)-4(c) (as amended in 1994).

43. For federal purposes, the estate receives a \$13,963,424 marital deduction, which is the gross estate (\$15,000,000) reduced by the federal estate tax (\$132,748) and Oklahoma estate tax (\$903,828). For Oklahoma purposes, the estate receives a \$4,175,217 marital deduction which represents the wife's income interest in the trust (29.9011% of the trust assets after the payment of federal and state death taxes). The income factor is based on the Oklahoma valuation table. *See OKLAHOMA TAX COMM'N, supra* note 36, at 40.

44. *See supra* notes 35-36 and accompanying text.

45. 68 OKLA. STAT. § 804 (1991).

46. I.R.C. § 2044 (1994).

47. *Id.* § 2011(b).

48. The federal credit for state death taxes is only available to the extent that those taxes are actually paid. If Oklahoma did not impose this additional tax, the federal tax burden would be correspondingly increased. *See id.* § 2011(a).

An issue exists with respect to whether the Oklahoma statute actually assesses this additional tax. For Oklahoma estate tax purposes, the statute excludes assets passing to the surviving spouse from the gross estate rather than including those assets and then allowing a corresponding deduction. *Compare* 68

tax of \$2,604,776 in both estates. If the husband gave \$15,000,000 directly to his children on his death, the Oklahoma estate tax would be only \$1,866,800.⁴⁹

A sophisticated Oklahoma estate planner would not advise the above decedent to utilize a QTIP trust and thus would avoid this \$737,976 penalty.⁵⁰ To achieve the optimum tax result, an Oklahoma resident either must make an outright bequest to his surviving spouse or must create a power of appointment trust. In either event, the decedent relinquishes the ability to select the trust's beneficiaries on his wife's death. The decedent cannot utilize a universal federal planning device without incurring a significant additional tax burden.

B. Special Use Valuation

Between 1970 and 1976, the value of agricultural land escalated.⁵¹ However, a corresponding increase in cash flow did not accompany this newfound wealth.⁵² The lack of liquidity, combined with a substantial estate tax liability, caused significant problems upon a farmer's or rancher's death.⁵³ In an effort to save the

OKLA. STAT. § 807(B) with I.R.C. §§ 2031, 2056. Oklahoma apportions the available federal credit based on "the percentage which the value of the property of the estate taxable in Oklahoma bears to the total value of the estate of the decedent." 68 OKLA. STAT. § 804. Assume that the surviving spouse was an Oklahoma resident and owned outright an equal amount of real estate in Oklahoma and Texas. Also assume that the QTIP trust was subject to the jurisdiction of the Oklahoma courts and would otherwise have been subject to Oklahoma estate tax. The QTIP trust is included in neither the numerator nor the denominator of the above fraction. Thus, the formula apportions only 50% of the available credit to Oklahoma, even though more than 50% of the federal credit is attributable to property located in Oklahoma. Note also that the Texas statute takes into account the inclusion of the QTIP trust in the spouse's gross estate and thus claims less than 50% of the available credit. TEX. TAX CODE ANN. § 211.052 (West 1992). Since Oklahoma and Texas claim less than the available credit, it correspondingly increases the federal estate tax. See I.R.C. § 2011(a).

49. This is the federal credit for state death taxes on a taxable estate of \$15,000,000 which exceeds the amount computed in accordance with the Oklahoma tax table. See I.R.C. § 2011(b); 68 OKLA. STAT. § 803(1).

50. Information with respect to this potential problem has been widely circulated. See e.g., 1 COFFMAN & JONES, *supra* note 35, § 12.2.3. However, cases continue to arise in which this mistake occurs.

51. For example, the average price of farm land in Oklahoma increased over 100% between 1971 and 1976. Darrel Kletke, Oklahoma Chapter of the Am. Soc'y of Farm Managers & Rural Appraisers, Spring Meeting (Apr. 21, 1995) (unpublished manuscript, on file with the *Oklahoma Law Review*). In Iowa, the average price of farm land in Iowa, for example, increased nearly 320% between 1970 and 1976. COOPERATIVE EXTENSION SERV., IOWA STATE UNIV., 1976 IOWA LAND VALUE SURVEY (1977). Between 1970 and 1976, the consumer price index increased 47%. Council of Economic Advisors, 95th Cong., 2d Sess., Economic Indicators, at 23.

52. Historically, persons purchasing farm land can anticipate a 3% return on their investment. See Donald H. Kelley, *The Farm Corporation as an Estate Planning Device*, 54 NEB. L. REV. 217, 218 (1975).

53. Prior to 1977, an estate received a \$60,000 exemption. I.R.C. § 2052 (1954), *repealed by* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001, 90 Stat. 1525, 1846. A decedent dying in 1977 received, instead, a unified credit of \$30,000 which sheltered a taxable estate of \$120,667. I.R.C. § 2010(b) (1977). If a decedent died in 1977 with a taxable estate of \$600,000 (an amount which is now completely sheltered from federal estate tax by virtue of I.R.C. § 2010(a)), the estate would have paid at least \$162,800 in federal estate and state death taxes. *Id.* § 2001(c).

family farm from the tax collector, Congress enacted section 2032A as part of the Tax Reform Act of 1976.⁵⁴ Section 2032A permits estates to value agricultural land for federal estate tax purposes based on its production value rather than its fair market value.⁵⁵ For estates that qualify, this normally results in a significant reduction in the value of the land and a corresponding reduction in the federal estate tax liability. The Internal Revenue Service has estimated that the special use value of qualifying Oklahoma real estate averages 36% of its fair market value.⁵⁶

Currently, twenty-eight states impose a death tax equal to the federal credit for state death taxes.⁵⁷ Since the computation of the allowable credit is based on the

An estate can pay the death taxes only from the following sources:

The first is from farm earnings. As we know from looking at farm earnings, the production costs in the industry now are frequently higher than the income from those assets. So farm earnings cannot be counted on to supply the funds.

The second is from nonfarm assets, but most farm[s] and ranches do not have sufficient nonfarm assets to pay the Federal estate tax.

The third place farmers and ranchers look to pay Federal estate tax is by borrowing the money, but farm and ranch indebtedness is already at record levels. Many farms and ranches are mortgaged to the hilt and cannot borrow money to pay the tax.

That leaves the fourth alternative. That is to sell part or all of the farm or ranchland to pay Federal estate taxes.

Federal Estate and Gift Taxes: Public Hearings and Panel Discussions Before the House Comm. on Ways and Means, 94th Cong. 356, 589 (1976) (comments by Samuel P. Guyton).

54. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525. The Joint Committee on Taxation explained the congressional purpose for enacting section 2032A:

The Congress believed that, when land is actually used for farming purposes or in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential "highest and best use" especially since it is desirable to encourage the continued use of property for farming and other small business purposes. Valuation on the basis of highest and best use, rather than actual use, may result in the imposition of substantially higher estate taxes. In some cases, the greater estate tax burden makes continuation of farming, or the closely held business activities, not feasible because the income potential from these activities is insufficient to service extended tax payments on loans obtained to pay the tax. Thus, the heirs may be forced to sell the land for development purposes.

STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 537 (Comm. Print 1976) [hereinafter EXPLANATION OF THE TAX REFORM ACT], reprinted in 1976-3 C.B. (Vol. 2) 1, 549. For an excellent discussion of the legislative history, see Martin D. Begleiter, *Section 2032A: Did We Save the Family Farm?*, 29 DRAKE L. REV. 15, 16-25 (1979-80).

55. Although there are three methods of valuing qualified property under section 2032A, most estates use the cash rental method. See I.R.C. § 2032A(e)(7)(A) (1994). For each of the five years preceding death, the estate determines the annual cash rental for comparable land, subtracts from that amount the annual real estate taxes for the comparable land, and then divides the result by the average Federal Land Bank interest rate. For a detailed explanation, see Treas. Reg. § 20.2032A-4 (1980).

56. STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., BACKGROUND ON REGULATIONS UNDER SECTIONS 482, 483, AND 2032A OF THE INTERNAL REVENUE CODE 12 (Comm. Print 1981). In other regions, the average reduction varied between 23% and 76%.

57. Under I.R.C. § 2011, an estate receives a credit against its federal estate tax for any death tax paid to a state. However, the credit can not exceed the amount computed in accordance with the table set forth in I.R.C. § 2011(b). A state death tax which is equal to the allowable federal credit for state

federal taxable estate, these states by implication have embraced the concept of special use valuation.⁵⁸ Fifteen of the remaining states which impose either an estate or inheritance tax have incorporated the provisions of section 2032A or have adopted a comparable section.⁵⁹ Only a limited number of states have failed to enact a provision similar to section 2032A.⁶⁰

The Oklahoma legislature recently granted preferential treatment for decedents dying after 1996 with respect to qualifying family businesses and farms.⁶¹ To the extent qualifying assets pass to the decedent's parents and descendants, the \$175,000 exemption is increased to \$600,000.⁶² An analysis of the differences between the Oklahoma and federal provisions is outside the scope of this article.⁶³ However, it is helpful to highlight some of the interpretational problems with which the Oklahoma courts will soon have to grapple.

death taxes is often referred to as a pick-up tax. Twenty-eight states impose a pick-up tax. *See* ALA. CODE §§ 40-15-1 to -19 (1993); ALASKA STAT. §§ 43.31.011-.430 (Michie 1990 & Supp. 1995); ARIZ. REV. STAT. ANN. §§ 42-1501 to -1522 (West 1991 & Supp. 1995); ARK. CODE ANN. §§ 26-59-101 to -122 (Michie 1987 & Supp. 1995); CAL. REV. & TAX. CODE §§ 13301-14302 (West 1994); COLO. REV. STAT. §§ 39-23.5-101 to -117 (1994); D.C. CODE ANN. §§ 47-3701 to -3723 (1990); FLA. STAT. ANN. §§ 198.01-.44 (West 1989 & Supp. 1996); GA. CODE ANN. §§ 91A-5701 to -5706 (Harrison 1996); HAW. REV. STAT. §§ 236D-1 to -18 (1993); IDAHO CODE §§ 14-401 to -413 (Supp. 1995); 35 ILL. COMP. STAT. ANN. 405/1-405/18 (West 1996); ME. REV. STAT. ANN. tit. 36, §§ 4061-4079 (West 1990 & Supp. 1995); MICH. COMP. LAWS ANN. §§ 205.231-.256 (West Supp. 1996); MINN. STAT. ANN. §§ 291.005-.47 (West 1991 & Supp. 1996); MO. ANN. STAT. §§ 145.009-.985 (West 1996); NEV. REV. STAT. §§ 375A.010-.885 (1995); N.M. STAT. ANN. §§ 7-7-1 to -20 (Michie 1996); N.D. CENT. CODE §§ 57-37.1-01 to -22 (1993 & Supp. 1995); R.I. GEN. LAWS §§ 44-22-1 to -2 (1995); S.C. CODE ANN. §§ 12-16-10 to -1950 (Law Co-op. Supp. 1995); TEX. TAX CODE ANN. §§ 211.001-.301 (West 1992 & Supp. 1996); UTAH CODE ANN. §§ 59-11-101 to -115 (1992 & Supp. 1996); VT. STAT. ANN. tit. 32, §§ 7401-7497 (1991 & Supp. 1995); VA. CODE ANN. §§ 58.1-900 to -938 (Michie 1991 & Supp. 1996); WASH. REV. CODE ANN. §§ 83.100.010-.905 (West Supp. 1996); W. VA. CODE §§ 11-11-1 to -42 (1995 & Supp. 1996); WIS. STAT. ANN. §§ 72.005-.35 (West 1989, Supp. 1995 & Supp. 1A 1996); WYO. STAT. ANN. §§ 39-6-810 to -813 (Michie 1994).

58. The federal credit for state death taxes is based on the adjusted taxable estate which is the taxable estate reduced by \$60,000. I.R.C. § 2011(b) (1994). An election to specially value qualifying real estate reduces the value of the real estate, gross estate, and the taxable estate. *Id.* §§ 2032A(a)(1), 2031(a), 2051.

59. CONN. GEN. STAT. ANN. § 12-349 (West 1993); DEL. CODE ANN. tit. 30, § 1314 (1985 & Supp. 1995); IND. CODE ANN. § 6-4.1-5-1.5 (Michie 1991); IOWA CODE ANN. §§ 450B.1-.7 (West 1990 & Supp. 1996); KAN. STAT. ANN. § 79-1545 (Supp. 1995); KY. REV. STAT. ANN. § 140.310 (Banks-Baldwin 1990); MD. CODE ANN., TAX-GEN. § 7-211 (1988); MASS. ANN. LAWS ch. 65C, § 5(c) (Law. Co-op. 1991); MISS. CODE ANN. § 27-9-8 (1991); MONT. CODE ANN. §§ 72-16-331 to -349 (1995); N.Y. TAX LAW § 954-a (McKinney 1987 & Supp. 1996); OHIO REV. CODE ANN. § 5731.011 (Anderson 1996); OR. REV. STAT. § 118.155 (Supp. 1994); 72 PA. CONS. STAT. ANN. § 9122 (West Supp. 1996); S.D. CODIFIED LAWS ANN. § 10-40-21 (Michie Supp. 1995); TENN. CODE ANN. § 67-8-412(c) (1994 & Supp. 3 1996).

60. Those states are Louisiana, Nebraska, New Hampshire, New Jersey, and North Carolina.

61. Act of June 12, 1996, ch. 334, sec. 3, § 809(B), 1996 Okla. Sess. Law Serv. 1533, 1534 (West) (codified at 68 OKLA. STAT. § 809(B) (Supp. 1996)) (effective Nov. 1, 1996).

62. *Id.*

63. One must question the utility of making detailed comparisons between the 515-word Oklahoma provision and the 5001-word federal version.

The statute places the following restrictions on the availability of the additional exemption:

1. A "qualifying family business or farm" must pass to a "qualifying heir."⁶⁴
2. A "qualifying heir" includes the decedent's parents and descendants.⁶⁵
3. A "qualifying family business or farm" is an interest in a closely held family corporation, sole proprietorship, partnership, limited liability company, or other unincorporated family business.⁶⁶
4. On the date of the decedent's death, the decedent or a qualifying heir was subject to self-employment tax on income earned from the business or was receiving wages from the business.⁶⁷
5. For five years prior to the decedent's death, there must have been continuous operation of the family business or farm.⁶⁸

There is also a requirement that the qualifying family business or farm continue the enterprise for a period of five years following the decedent's death. If this requirement is not satisfied, the qualified heirs are liable for 20% of the tax savings for each year that evidence of continuous operation is not submitted.⁶⁹

Although a qualifying estate can save up to \$47,500 in Oklahoma estate tax, the average savings will normally be less.⁷⁰ There is still ample incentive to explore the provision's scope, since there is no better test of the drafter's skill than a tax practitioner's ingenuity. In this regard, the statute leaves many unresolved issues.

First of all, if a business or farm is owned by a corporation, the additional exemption is available only if the decedent and not more than ten qualifying heirs control the corporation.⁷¹ Since no similar limitation is placed on partnerships and limited liability companies, presumably any business or farm interest owned by those entities would qualify regardless of whether the decedent and qualified heirs own a controlling interest.⁷²

64. Act of June 12, 1996, § 809(B), 1996 Okla. Sess. Law Serv. at 1534.

65. *Id.* § 809(B)(4). As explained in note 5, *supra*, this includes "the father, mother, child, child of husband or wife, adopted child, or any lineal descendant of decedent or of such adopted child." *Id.* § 809(A). This is more restrictive than the federal definition of qualified heirs which includes the decedent's ancestors and lineal descendants of the decedent's parents (including those descendants' spouses). See I.R.C. § 2032A(e)(2) (1994).

66. Act of June 12, 1996, § 809(B)(2), 1996 Okla. Sess. Law Serv. at 1534. Note that the Oklahoma provision applies to all business interests, whereas the federal is limited to real estate.

67. *Id.* § 809(B)(2).

68. *Id.* § 809(C).

69. *Id.*

70. The maximum savings result only when the taxable estate prior to the application of the exemption is in excess of \$10,600,000 causing the estate to fall within the highest marginal tax bracket. 68 OKLA. STAT. § 803(1) (1991). If a decedent's taxable estate prior to the exemption is \$1,000,000, half of which comprised qualifying assets, the savings would be \$29,625. *Id.*

71. Section 809(B)(3), 1996 Okla. Sess. Law Serv., at 1534-35. Control is defined to mean 50% of the total combined voting power of all classes of stock entitled to vote and 50% of all other classes of stock. *Id.*

72. Due to the lack of legislative history, it is impossible to determine whether the legislature intended this unlikely result. Compare I.R.C. § 2032A(g) which requires corporations, partnerships, and

It is unclear whether the Oklahoma provision applies to a business interest which the decedent transferred to a trust. The creation and funding of revocable inter vivos trusts has been a popular estate planning device for years, and it is clear that such a trust is included in the Oklahoma gross estate.⁷³ The statute expressly covers business interests owned by closely held family corporations, sole proprietorships, partnerships, limited liability companies, and other unincorporated family businesses, but fails to mention trusts.⁷⁴ This issue is closely related to the question of whether business interests held in trust "pass" to the qualified heirs within the meaning of section 809(B).⁷⁵ There is no logical reason why the legislature would have wanted to exclude such interests from application of section 809(B).⁷⁶

There are two pre-death prerequisites relating to the level of participation in the business. At the time of the decedent's death, the income generated by the business must be subject to self-employment taxes with respect to the decedent (or a qualifying heir), or the decedent (or a qualifying heir) must have been receiving wages from the business.⁷⁷ The first alternative guarantees that the decedent (or qualifying heir) is actively participating in the business rather than acting as a passive investor.⁷⁸ However, the alternative test is satisfied where the decedent (or a qualifying heir) received a small salary for insignificant services unrelated to the qualifying business or farm.⁷⁹

The second pre-death requirement is even more vague. The estate must submit tax returns or schedules for the business interest, showing proof of its "continuous operation."⁸⁰ Presumably, this requires the decedent to own the business or farm for five years prior to death.⁸¹ However, it is unclear who must participate

trusts to satisfy the closely held standards set forth in I.R.C. § 6166(b).

73. 68 OKLA. STAT. § 807(A)(3) (1991).

74. Act of June 12, 1996, § 809(B)(2), 1996 Okla. Sess. Law Serv. at 1534 (West). An estate can argue, of course, that a farm owned by a trust is an "unincorporated family business." Compare I.R.C. § 2032A(g) (1994) (authorizing the Treasury to prescribe regulations setting forth the application of special use valuation to interests in trusts).

75. Compare I.R.C. § 2032A(e)(9)(C) (stating that property acquired from a decedent includes property held in trust).

76. There also is no express requirement that the qualifying family business or farm be included in the decedent's gross estate. Compare *id.* § 2032A(e)(9). It seems likely that the court would imply such a requirement, foreclosing the argument that an estate is entitled to the increased exemption as the result of a lifetime transfer to a trust in which the decedent failed to retain sufficient interest to result in its inclusion in the gross estate.

77. Act of June 12, 1996, § 809(B)(2), 1996 Okla. Sess. Law Serv. at 1534.

78. This is generally the same requirement imposed by I.R.C. § 2032A(e)(6). Both Congress and the Oklahoma legislature intended to grant a targeted tax break to business owners and farmers, not investors.

79. Under the federal provision, the decedent (or member of the decedent's family) must materially participate for five of eight years prior to the decedent's death, and material participation is determined in a manner similar to the standard used for purposes of determining earnings from self-employment. See *id.* § 2032A(b)(1)(C)(ii), (e)(6).

80. Act of June 12, 1996, § 809(C), 1996 Okla. Sess. Law Serv. at 1535.

81. There is a similar requirement under the federal provision. See I.R.C. § 2032A(b)(1)(C) (1994).

during this five-year period and what degree of activity rises to the level of "continuous operation." Clearly the statute requires more than mere ownership of the property for five years. The most logical interpretation is that the business must generate self-employment income or wages during the entire five-year period, incorporating the participation test applied at the decedent's date of death.⁸²

After death, the

qualifying family business or farm shall also be required to continue the business or farm for a period of five (5) years following the date of death of the decedent and shall submit each taxable year the appropriate tax returns or tax schedules to the Oklahoma Tax Commission as proof of continuous operation of the business or farm.⁸³

This raises several issues with respect to postdeath participation. Although the statute requires the qualifying business or farm to continue the interest, it seems likely that the legislature intended the qualifying heirs to continue the business or farm.⁸⁴ It is also unclear whether continued operation after the decedent's death is measured by the predeath participation standard.⁸⁵

If the postdeath participation requirement is not satisfied, the qualifying heirs become liable for the recaptured tax.⁸⁶ This arguably imposes liability on all qualified heirs, regardless of whether they received the qualifying family business or farm.⁸⁷ Furthermore, the statute fails to impose a continuing lien against the business interest for the potential recapture tax, jeopardizing the state's ability to actually collect that tax.⁸⁸

The Oklahoma Office of State Finance has estimated that 25% of all estates passing to the decedent's parents and descendants may qualify for the increased exemption.⁸⁹ However, the legislation is so poorly drafted that it will invite virtually every estate to argue that the decedent owned a qualifying business or farm.

Although the scope of the Oklahoma legislation is generally broader than section 2032A,⁹⁰ the legislature should have considered incorporating the re-

82. It is unlikely that the two sections would impose a completely different test for material participation prior to the decedent's death. Unless a contrary result was intended, one must wonder why the legislature would leave this issue in doubt.

83. Act of June 12, 1996, § 809(C), 1996 Okla. Sess. Law Serv. at 1535.

84. It is also likely that the legislature intended that those qualifying heirs who actually received the property continue the operation of the business or farm, but this is unclear. Compare I.R.C. § 2032A(c)(1) (requiring the beneficiary to maintain the qualified use).

85. See *supra* note 67 and accompanying text.

86. Act of June 12, 1996, § 809(C), 1996 Okla. Sess. Law Serv. at 1535.

87. Compare I.R.C. § 2032A(c)(5) (imposing personal liability on only those beneficiaries who receive the qualifying property).

88. Compare I.R.C. § 6324B.

89. Letter from Tony Mastin, Director of the Oklahoma Tax Commission, to Mark R. Gillett (June 21, 1996) (on file with the *Oklahoma Law Review*).

90. As previously noted, the Oklahoma provision is not limited to real estate as is I.R.C. § 2032A.

quirements of section 2032A rather than attempting to draft new legislation. For two decades, federal courts have been defining the statute's scope,⁹¹ and Congress has been refining the statutory language.⁹² The result is an extremely complex piece of legislation designed to thwart tax practitioners' attempts to expand its scope beyond the intended beneficiaries.⁹³ However, incorporating the provisions of section 2032A into the Oklahoma estate tax adds no additional complexity.

Nor is the valuation approach employed by section 2032A foreign to the Oklahoma legislature. In 1988, the Oklahoma legislature enacted a provision which based the value of agricultural land for ad valorem tax purposes on an income capitalization approach using cash rentals.⁹⁴ The capitalization rate is determined annually based on the average interest rate charged by the Federal Land Bank for the previous five years.⁹⁵ As a result, agricultural land is taxed only on its agricultural value. This valuation mechanism is virtually identical to that adopted twelve years earlier in section 2032A.⁹⁶

However, the results can sometimes be surprising. Assume that the decedent's \$1,200,000 estate includes \$600,000 of real estate which passes to the decedent's siblings and which qualifies for special use valuation. If the estate elects special use valuation, the value of the real estate for federal purposes will be 36% of its fair market value, or \$216,000. *See supra* note 56. If the real estate were not included in the decedent's estate, the federal estate tax burden would be \$192,800 which is the federal tax on \$600,000. *See* I.R.C. § 2001(c)(1) (1994). If the real estate is included at its special use value, federal tax increases to \$272,480. *See id.* As a result, the inclusion of the real estate causes an additional \$79,680 of federal tax (before taking into account the unified credit or credit for state death taxes).

Since the real estate passes to the decedent's siblings, the estate does not qualify for the increased exemption. Act of June 12, 1996, § 809(B), 1996 Okla. Sess. Law Serv. at 1535. The Oklahoma estate tax attributable to the inclusion of the real estate is \$86,000, which is the difference between the Oklahoma tax on \$1,200,000 and the tax on \$600,000. *See* 68 OKLA. STAT. § 803(1) (1991). In this example, the Oklahoma tax burden actually exceeds the federal.

91. I.R.C. § 2032A has been referenced in over 130 cases. Search of Westlaw, Allcases Database (Dec. 12, 1996).

92. I.R.C. § 2032A has been amended nine times since its initial enactment. *See* Act of Oct. 17, 1978, Pub. L. No. 95-472, 92 Stat. 1332, 1334-35; Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2928-29; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172, 306-12; Technical Corrections Act of 1982, Pub. L. No. 97-448, 96 Stat. 2365, 2381-82 (1983); Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 1030-31; Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2105, 2716; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3724-25; Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-400, 1388-530.

93. Neil E. Harl, *Special Use Valuation: The Standout from TRA '76*, TR. & EST., Apr. 1983, at 12.

From the standpoint of complexity, the consensus of many planners and those involved in probate is that special use valuation, considering the original statute, amendments, regulations and rulings, has become the most complex provision from the Tax Reform Act of 1976 and is well on its way to becoming the most complex provision in the Internal Revenue Code.

Id.

94. *See* Ad Valorem Tax Code Act, ch. 162, § 17, 1988 Okla. Sess. Laws 593, 593-96 (codified at 68 OKLA. STAT. § 2817(C) (1991)).

95. 68 OKLA. STAT. § 2817(C)(4) (1991).

96. *See* I.R.C. § 2032A(e)(7)(A) (1994). *See supra* note 55.

C. Deferral of Tax Relating to Closely Held Businesses

If the statutory requirements are satisfied, section 6166 authorizes estates to defer that portion of the federal estate tax attributable to closely held business interests.⁹⁷ The Internal Revenue Code has long granted discretion to the Service to authorize extensions to pay estate tax to alleviate liquidity problems.⁹⁸ In 1958, Congress enacted the predecessor to section 6166, acknowledging that the special circumstances which arise when an estate is substantially comprised of business interests mandate that the Service grant an extension.⁹⁹ An additional deferral provision, which lengthened the deferral period and provided that a portion of the unpaid tax accrue interest at a preferential rate, was enacted in 1976.¹⁰⁰

Congress consolidated and liberalized the two deferral provisions in 1981.¹⁰¹ The current section 6166 bestows several benefits on qualifying estates. First, estates can elect to defer the payment of federal estate tax for up to fourteen years.¹⁰² Second, interest on the first \$153,000 of deferred tax accrues at a 4% rate, while the balance accrues interest at the statutory rate.¹⁰³ Furthermore, the interest is deductible for income tax purposes¹⁰⁴ or as an administration expense for estate tax purposes.¹⁰⁵

97. A closely held business interest is a trade or business operated as a proprietorship or in certain partnerships and corporations. *See* I.R.C. § 6166(b)(1) (1994). An estate can elect to defer an amount equal to the total federal estate tax times a fraction, the numerator of which is the value of the closely held business and the denominator of which is the value of the adjusted gross estate. *See id.* § 6166(a)(2), (b).

98. Prior to 1977, the taxpayer was required to establish "undue hardship" to obtain an extension. I.R.C. § 6161(b) (1976). The standard was liberalized in 1976 to authorize extensions for "reasonable cause" in an effort to compel the Service to grant relief in more cases. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2004(c), 90 Stat. 1520, 1867-68; STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 543-51 (Comm. Print 1976), reprinted in 1976-3 C.B. (Vol. 2) 1, 555-63.

99. *See* Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, § 206(a), 72 Stat. 1676, 1681-85. Under this provision, estates were granted an extension of up to ten years to pay the federal estate tax attributable to closely held business interests. Deferred amounts accrued interest at the same rate applicable to other underpayments of federal estate tax. *See* I.R.C. § 6601 (1958).

100. *See* I.R.C. § 6166 (added by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2004(a), (b), 90 Stat. 1520, 1862-67). The existing deferral section was renumbered I.R.C. § 6166A. The preferential rate applied only with respect to taxes deferred pursuant to the new provision. I.R.C. § 6601(j) (1976). Taxes deferred pursuant to I.R.C. § 6166A accrued interest at the statutory rate. *Id.*

101. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 422, 95 Stat. 172, 314-16. For example, the 1981 legislation retained the longer deferral period and the 4% interest rate of one provision, but used the lower threshold requirements of the other. For a detailed discussion of the changes, see Susan K. Smith & Samuel P. Guyton, *New Law Makes it Easier to Qualify for Estate Tax Deferral and Sec. 303 Redemptions*, 56 J. TAX'N 14 (1982).

102. An estate can elect to pay the deferred tax in ten equal installments, with the first installment due five years after the original due date of the estate tax return. I.R.C. § 6166(a)(3) (1994). Interest is due on the unpaid portion annually.

103. *Id.* § 6601(a), (j).

104. Interest on taxes deferred pursuant to I.R.C. § 6166 is excluded from the definition of non-deductible personal interest. *Id.* § 163(h)(2)(E).

105. In *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977), *acq. in result* Rev. Rul. 78-125, 1975-1

Congress has succinctly stated the reasons for granting this preferential treatment to owners of small businesses:

[The prior law] proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist [sic] of a closely held business or other illiquid assets. In many cases, the executor was forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax. This may have occurred even when the estate qualified for the 10-year extension provided for closely held businesses. In these cases, it may have taken several years before a business could regain sufficient financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners. Moreover, some businesses were not so profitable that they yielded enough to pay both the estate tax and interest especially if the interest rate was high.¹⁰⁶

The elections to specially value real estate¹⁰⁷ and to defer the payment of estate taxes work in tandem to reduce the estate tax burden on qualifying estates. An estate which qualifies for special use valuation generally can also elect to defer the estate tax attributable to the farming or ranching operation.¹⁰⁸

The Oklahoma statute authorizes the Tax Commission to establish regulations with respect to postponing the payment of estate tax.¹⁰⁹ However, the statute fails to establish a standard for review, and the regulations which the Commission has promulgated discuss only the procedural aspects for obtaining relief.¹¹⁰ Even

C.B. 292, the Tax Court permitted an estate to deduct interest on tax deferred pursuant to I.R.C. § 6166 as an administrative expense pursuant to I.R.C. § 2053(a)(2). However, the deduction is only allowed as the interest is paid, thus necessitating the annual filing of supplemental estate tax returns. See *Estate of Bailly v. Commissioner*, 81 T.C. 246, *reconsidered*, 81 T.C. 949 (1983). The Service has established the procedure which an estate must follow to claim the deduction. See Rev. Proc. 81-27, 1981-2 C.B. 548.

The interest is not allowed as a deduction for both income and estate tax purposes. See I.R.C. § 642(g) (1994). The deduction for estate tax purposes is usually more valuable. However, it does give rise to a particularly complex interrelated computation since the additional deduction reduces the federal estate tax, thus reducing the amount of deferred tax and the amount of interest on that deferred tax. An estate can request the Service to perform this computation. See, e.g., Priv. Ltr. Rul. 86-39-056 (June 30, 1986).

106. See STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 546 (Comm. Print 1976), *reprinted in* 1976-3 C.B. (Vol. 2) 1, 558. Since the investment return on farm land averages 3%, farm estates exemplify this liquidity problem. See *supra* note 52.

107. See *supra* notes 54-56 and accompanying text.

108. To make the special use election, 50% of the adjusted gross estate must comprise qualified real and personal property. See I.R.C. § 2032A(b)(1)(A) (1994). Only 35% of the adjusted gross estate must consist of closely held business interests to defer the payment of estate taxes. See *id.* § 6166(a)(1). However, a farm or ranch qualifying for special use valuation may not be a closely held business interest for purposes of I.R.C. § 6166. See *id.* § 6166(b).

109. 68 OKLA. STAT. § 806(b) (1991).

110. See Oklahoma Tax Comm'n Rules, tit. 710, ch. 35, § 710:35-3-5 (1994) ("Requests for estate tax payment plans should be made in writing to the Estate Tax Section Administrator.").

if the Estate Tax Section Administrator grants an estate's request, the deferred tax accrues interest at the same rate applied to other underpayments, currently 15%.¹¹¹

Although fifteen states authorize estates to specially value real estate,¹¹² only eleven have enacted provisions similar to section 6166.¹¹³ Nevertheless, the impact of the Oklahoma estate tax on residents owning closely held businesses can still be substantial, particularly in light of the applicable interest rate on deferrals. The increased Oklahoma exemption for qualifying family businesses and farms only partially ameliorates the problem.¹¹⁴

If the federal government is willing to grant relief to promote and facilitate the continuation of family-owned businesses, it is appropriate that the Oklahoma legislature also respond.¹¹⁵ At a minimum, the legislature should reduce the current confiscatory interest rate on underpayments and mandate that the Administrator apply a standard such as "reasonable cause"¹¹⁶ to determine whether to grant an estate's request to defer Oklahoma estate tax.¹¹⁷

D. Gifts Within Three Years of Death

The federal estate tax preceded the gift tax by sixteen years.¹¹⁸ To preserve the integrity of the estate tax, Congress provided that certain transfers made during the decedent's life, including transfers made in contemplation of death,

111. 68 OKLA. STAT. § 806(a) (1991).

112. See *supra* note 59 and accompanying text.

113. See ARIZ. REV. STAT. ANN. § 42-1504(C) (West 1991); ARK. CODE ANN. § 26-59-113(c) (Michie Supp. 1995); COLO. REV. STAT. § 39-23.5-108 (1994); CONN. GEN. STAT. ANN. § 12-376b (West Supp. 1996); KAN. STAT. ANN. § 79-1566 (1989); KY. REV. STAT. ANN. § 140.151 (Banks-Baldwin Supp. 1995); MINN. STAT. ANN. § 289A.30 (West Supp. 1996); MO. ANN. STAT. § 145.551 (West 1996); MONT. CODE ANN. § 72-16-452 (1995); N.Y. TAX LAW § 997 (McKinney Supp. 1996); WIS. STAT. ANN. § 72.225 (West Supp. 2A 1996).

114. See *supra* notes 61-62 and accompanying text. The maximum tax savings as a result of the increased exemption is \$47,500, and the Oklahoma estate tax on farm and ranch land can actually exceed the federal estate tax. See *supra* note 90. As a result, the Oklahoma estate tax can still impose a significant burden on family businesses.

115. It is important to note that the enactment of an Oklahoma provision similar to I.R.C. § 6166 merely would postpone the payment of Oklahoma estate tax rather than reduce the amount of tax owing.

116. This is the standard which the Service must apply to determine whether an estate which does not fall within I.R.C. §§ 6163 and 6166 should receive an extension to pay federal estate tax. See I.R.C. § 6161(b)(2) (1994). See *supra* note 98.

117. The interest rate on underpayments of Oklahoma estate tax was last modified in 1988 at which time the federal rate was 11%. See 1988 Okla. Sess. Laws 265; Rev. Rul. 95-78, 1995-2 C.B. 269. Perhaps the Oklahoma legislature should adopt the federal rate for underpayments which is adjusted quarterly. See I.R.C. § 6621 (1994).

118. The federal estate tax was enacted in 1916. See Revenue Act of 1916, Pub. L. No. 64-271, §§ 200-12, 39 Stat. 756, 777-80. A gift tax was enacted in 1924, but Congress repealed that version in 1926. See Revenue Act of 1924, Pub. L. No. 68-176, §§ 319-24, 43 Stat. 253, 313-16; Revenue Act of 1926, Pub. L. No. 69-20, § 1200, 44 Stat. 9, 125-26. The precursor to the current gift tax appeared in 1932. See Revenue Act of 1932, Pub. L. No. 72-154, §§ 501-32, 47 Stat. 169, 245-59. For a detailed discussion of the history of I.R.C. § 2035, see RICHARD B. STEPHENS ET AL., FEDERAL ESTATE AND GIFT TAXATION ¶ 4.07[1], [4] (6th ed. 1991).

were brought back into the gross estate.¹¹⁹ Prior to 1977, gifts made within three years of death were presumed to be in contemplation of death.¹²⁰

Congress amended section 2035 in 1976 to include all transfers made within three years of death, thus eliminating the need to litigate the motive for the transfer.¹²¹ Congress also recognized that the concurrent adoption of a unified rate schedule for estate and gift taxes largely obviated the need for the provision.¹²² However, it remained concerned that without section 2035, any postgift appreciation would escape taxation.¹²³

Congress reversed itself five years later, generally excepting from the application of section 2035 decedents dying after 1981.¹²⁴ The statute currently includes in the gross estate only transfers of life insurance and other specified interests within three years of death, where the property's gift tax value is anticipated to be significantly less than its estate tax value.¹²⁵

When Oklahoma enacted an estate tax in 1935, the statute provided that a transfer of a material part of the decedent's estate within two years of death was presumed to be in contemplation of death and included in the decedent's gross estate at the value as of the original transfer.¹²⁶ The provision was amended in 1939 to include those assets at their date of death value.¹²⁷ As amended, the provision generally paralleled the federal statute in effect at the time.¹²⁸ The Oklahoma provision was amended again in 1973 to lengthen the presumptive

119. See Revenue Act of 1916, Pub. L. No. 64-271, § 202(b), 39 Stat. 756, 777-78.

120. I.R.C. § 2035(a) (1954).

121. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(5), 90 Stat. 1520, 1848-49; STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 527 (Comm. Print 1976), reprinted in 1976-3 C.B. (Vol. 2) 1, 538-39.

122. See *infra* notes 142-44 and accompanying text.

123. STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 528-29 (Comm. Print 1976), reprinted in 1976-3 C.B. (Vol. 2) 1, 540-41.

124. I.R.C. § 2035(d)(1) (1994) (added by Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 424, 95 Stat. 172, 317).

125. See *id.* § 2035(d)(2)-(4); H.R. REP. NO. 97-201, at 186-87 (1986), reprinted in 1981-2 C.B. 352, 390. For example, the value of a life insurance policy for gift tax purposes is established by the sale of comparable contracts by the insurance company, or, if the policy has been in force for a period of years, by the policy's interpolated terminal reserve. Treas. Reg. § 25.2512-6(a) (1974). In either case, assuming that the decedent is in good health at the time of the transfer, the gift tax value is significantly less than the policy proceeds which would be included under I.R.C. § 2042 if the decedent retained ownership.

It is more than a coincidence that the change to I.R.C. § 2035 was accompanied by the adoption of the unlimited marital deduction and the increase of the unified credit from \$47,000 to \$192,800. See Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, §§ 401, 403(a), 95 Stat. 172, 299-301. The change to I.R.C. § 2035 prevents estates exempt from federal estate tax from obtaining a free step-up in basis with respect to postgift appreciation. See I.R.C. § 1014(a) (1994).

126. Act of Apr. 23, 1955, ch. 66, art. 5, § 2, 1935 Okla. Sess. Laws 268, 274-75.

127. Act of Apr. 10, 1939, ch. 66, art. 9, § 6, 1939 Okla. Sess. Laws 365, 423-24.

128. I.R.C. § 803(c) (1939) (as amended by Revenue Act of 1932, Pub. L. No. 72-154, § 803(a), 47 Stat. 169, 279).

period from two to three years.¹²⁹ Section 807(A) currently provides that the value of the gross estate includes:

(2) The value of any real or personal property, including the homestead passing by deed, grant, bargain, sale or gift made in contemplation of death of the grantor, vendor, or donor, or intended to take effect in possession or enjoyment at or after his death. Any transfer made by the decedent of a material part of his estate within three (3) years prior to death, without an equivalent in monetary consideration, shall, unless shown to the contrary, be deemed to have been in contemplation of death, and such transfers shall be included at their net value at the date of decedent's death.¹³⁰

Since Oklahoma does not have a gift tax,¹³¹ it is imperative that Oklahoma prevent taxpayers from depleting their gross estates by making deathbed transfers.¹³² In theory, the above provision should effectively address this contingency.

Section 804(a)(2) appears to contain two separate attacks against transfers in contemplation of death. The first prong would include in the gross estate all transfers in contemplation of death, whenever made. Under the second prong, a transfer of a material part of the decedent's estate within three years of death shifts the burden of proof to the estate to establish that the transfer was not in contemplation of death.¹³³ However, the Oklahoma Supreme Court has determined that the statute applies only with respect to transfers of a material portion of the decedent's estate within three years of death.¹³⁴ As interpreted, the statute has two serious defects.

129. Act of May 17, 1973, ch. 206, § 3, 1973 Okla. Sess. Laws 342, 344-47. This change occurred 23 years after a corresponding change was made in the federal provision. See Revenue Act of 1950, Pub. L. No. 81-814, § 501(a), 64 Stat. 906, 962.

130. 68 OKLA. STAT. § 807(A)(2) (1991).

131. Oklahoma enacted a gift tax in 1941, six years after the estate tax. See Act of May 16, 1941, ch. 22a, 1941 Okla. Sess. Laws 377 (codified at 68 OKLA. STAT. §§ 1041-1047 (1941)). See *supra* note 11. The legislature repealed the gift tax for transfers made after 1981. See Act of June 22, 1981, ch. 237, § 5, 1981 Okla. Sess. Laws 566, 570-71.

132. For federal transfer tax purposes, there is no disincentive to discourage decedents from making transfers within three years of death. Without such a provision, the Oklahoma estate tax could be avoided without any corresponding federal transfer tax exposure. There may be other adverse tax consequences. Compare, e.g., I.R.C. § 1015 (1994) (granting a carryover basis with respect to property acquired by gift) with *id.* § 1014 (granting a step-up basis with respect to property acquired from a decedent).

133. In reality, a presumption that a transfer is in contemplation of death merely restates the burden of proof which the taxpayer already bears in Oklahoma. See 68 OKLA. STAT. § 815(b) (Supp. 1995); *McGill v. Oklahoma Tax Comm'n*, 258 P.2d 1180, 1182 (Okla. 1953). This anomaly also existed with respect to the federal provision before Congress made the presumption irrebuttable in 1976. See *supra* note 121 and accompanying text.

134. See *Wilson v. Oklahoma Tax Comm'n*, 594 P.2d 1210, 1213 (Okla. 1979) (expressly rejecting the Commission's argument that gifts outside the statutory period might still be in contemplation of death within the meaning of the statute).

An estate can argue that transfers within three years of death did not comprise a material part of the decedent's estate. Even though this language has been part of the statute since 1935, the courts have never interpreted this language. However, tax statutes are construed strictly, and the courts resolve all ambiguities in the taxpayer's favor.¹³⁵ The requirement that there be a material lifetime transfer also implies that a gift by a donor of moderate wealth could fall within the statute's scope while the same gift by a wealthy individual could escape inclusion, clearly an unfair result.

Even if the court determines that the transfer was material, an estate can still argue that the decedent did not make the transfer in contemplation of death. Although there are no Oklahoma cases on point, there are numerous federal decisions interpreting similar language in section 2035 prior to 1977.¹³⁶ It was this morass of inconsistent decisions which prompted Congress to amend the federal provision to automatically include in the gross estate all transfers made within three years of death.¹³⁷

The above limitations severely restrict the Oklahoma statute's effectiveness. This is evidenced by the fact that there is little litigation with respect to transfers made in contemplation of death, apparently reflecting the Oklahoma Tax Commission's unwillingness to litigate the issue.¹³⁸ This hesitancy is well founded since the Oklahoma courts have never included a transfer in the decedent's gross estate as being made in contemplation of death.¹³⁹

The current Oklahoma provision does not effectively deter residents from depleting their estates by making deathbed transfers. The legislature should amend section 807(A)(2) to require all transfers made within three years of death to be included in the decedent's gross estate, regardless of motive.¹⁴⁰ It is also necessary to include an exception with respect to transfers for which a federal gift tax return is not required, including transfers qualifying for the \$10,000 annual gift tax exclusion.¹⁴¹ This exclusion could be viewed as a substitute for the

135. See, e.g., *Wilson v. Oklahoma Tax Comm'n*, 594 P.2d 1210, 1212 (Okla. 1979); *C.H. Leavell & Co. v. Oklahoma Tax Comm'n*, 450 P.2d 211, 215 (Okla. 1968); *Fort Howard Paper Co. v. Oklahoma Tax Comm'n*, 792 P.2d 87, 89-90 (Okla. Ct. App. 1989).

136. The meaning of "contemplation of death" is outside the scope of this article. See, e.g., E. Jackson Boas, *The Specter of Gifts in Contemplation of Death*, 19 TUL. TAX INST. 409, 412-13 (1970); James W. Quiggle, *Recent Developments in Contemplation of Death*, 25 INST. ON FED. TAX'N 1047, 1049-51 (1967).

137. See *supra* note 121 and accompanying text.

138. The only other inference is that executors voluntarily and consistently report transfers of material portions of the decedent's estate made within three years of death. This seems improbable since case law favors the taxpayers and assets transferred during the decedent's life would otherwise escape Oklahoma taxation.

139. There is only one Oklahoma case where the decedent's motivation in making lifetime transfers has been litigated. In *Oklahoma Tax Commission v. Harris*, 455 P.2d 61, 69-74 (Okla. 1969), the court held that the decedent's payment of life insurance premiums prior to death did not result in the insurance proceeds being included in the decedent's gross estate. Compare *Estate of Leder v. Commissioner*, 893 F.2d 237 (10th Cir. 1989), *action on decision*, 1991-012 (July 3, 1991).

140. Compare I.R.C. § 2035(a), (d)(1) (1994) (taking a similar approach).

141. Compare *id.* § 2035(b)(2). That exception should also exclude transfers qualifying for the

materiality requirement in the current legislation and would avoid the obvious tracing problems resulting if all transfers within three years of death were brought back into the gross estate.

E. Exemption

Prior to 1977, estates received a \$60,000 specific exemption for federal estate tax purposes, which was treated as a deduction reducing the size of the taxable estate.¹⁴² When Congress unified the gift and estate taxes in 1976, it replaced the exemption with a credit which phased in over five years.¹⁴³ Since the prior exemption was treated as a deduction, it reduced an estate's tax burden at the highest marginal tax rate. Congress believed that a credit was more equitable since it conferred more tax savings on smaller estates. For decedents dying after 1980, the credit was \$47,000, which was sufficient to shelter a taxable estate of \$175,625.¹⁴⁴

In 1981, Congress increased the credit to its current level of \$192,800, which shelters a taxable estate of \$600,000.¹⁴⁵ When combined with the unlimited marital deduction, which also was enacted in 1981,¹⁴⁶ Congress enabled a husband and wife to pass \$1,200,000 to their descendants without the payment of federal estate tax.¹⁴⁷

Oklahoma has an exemption with respect to property that passes to the decedent's parents and descendants.¹⁴⁸ In 1973, this exemption was increased from \$15,000 to \$60,000, which was the federal amount.¹⁴⁹ In 1981, the exemption was increased to \$175,000, again to match the federal level.¹⁵⁰ In 1996, the legislature increased the exemption to the current federal level, but the additional exemption is only available to the extent that the decedent passes

educational or medical exclusion contained in I.R.C. § 2503(b)(e).

142. I.R.C. § 2052 (1976) (repealed by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(a)(4), 90 Stat. 1520, 1848). The exemption was increased from \$40,000 to \$60,000 in 1942. Revenue Act of 1942, Pub. L. No. 77-753, § 413, 56 Stat. 798, 951. Prior to 1977, individuals also received a \$30,000 lifetime exemption for gift tax purposes. I.R.C. § 2521 (1976) (repealed by Tax Reform Act of 1976, Pub. L. No. 94-455, § 2001(b)(3), 90 Stat. 1520, 1849).

143. STAFF OF THE JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 530-32 (Comm. Print 1976), reprinted in 1976-3 C.B. (Vol. 2) 1, 542-44.

144. *Id.* Unlike the earlier exemption, the unified credit applied to both lifetime and testamentary transfers. I.R.C. §§ 2010(1), 2505(a) (1994).

145. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 401(a)(1), 95 Stat. 172, 299. The increase was phased in over a six year period.

146. *See supra* note 19.

147. To accomplish this, both spouses must fully utilize the unified credit in their estates and must receive only moderately competent planning advice. *See* Larry E. Phillips, *Planning for the Use of the Unified Credit*, 41 INST. ON FED. TAX'N §§ 47.01-.08 (1983).

148. Other related individuals also qualify for this exemption. *See supra* note 5.

149. Act of May 17, 1973, ch. 206, § 5, 1973 Okla. Sess. Laws 342, 349. However, the Oklahoma exemption only applied to transfers to those individuals enumerated in title 68, section 809(A) of the Oklahoma Statutes while the federal exemption applied to all beneficiaries. *See* I.R.C. § 2511 (1973).

150. *See* Act of June 22, 1981, ch. 237, § 3, 1981 Okla. Sess. Laws 566, 568.

qualifying family businesses or farms to qualifying heirs.¹⁵¹ The \$175,000 exemption has actually decreased in real dollars to \$110,300 as a result of increases in the consumer price index occurring since 1981.¹⁵² As a result, assuming that the decedent made no lifetime gifts and did not own a qualifying family business or farm, an estate of \$600,000 passing to the decedent's children will not give rise to federal estate tax but will result in the imposition of almost \$18,000 of Oklahoma estate tax.¹⁵³

It is important to mention two additional factors. For property which passes to beneficiaries other than the decedent's parents and descendants, the estate receives only a \$100 exemption.¹⁵⁴ Note also that the exemption in Oklahoma is treated as a deduction rather than a credit, resulting in a greater tax benefit to the wealthy.¹⁵⁵ Assuming that an estate qualifies for the \$175,000 exemption, the wealthiest taxpayers receive a \$17,500 tax benefit¹⁵⁶ while more moderate estates receive only a \$4100 benefit.¹⁵⁷

Even if the Oklahoma legislature were to eliminate the exemption, it would have little impact on estate planners. Since the federal tax rates are higher, and because of the progressive nature of both tax systems,¹⁵⁸ a couple can still achieve significant overall tax savings if the first spouse to die transfers \$600,000 to descendants or to a trust which does not qualify for the marital deduction. The federal tax savings are usually greater than the additional Oklahoma estate tax, which can be as high as \$18,000.¹⁵⁹

Recent efforts have been made to increase the exemption.¹⁶⁰ However, the legislature can revamp the Oklahoma estate tax without changing the exemption,

151. See Act of June 12, 1996, ch. 334, 1996 Okla. Sess. Law Serv. 1533.

152. See U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 487 (1994).

153. 68 OKLA. STAT. § 803(1) (1991).

154. 68 OKLA. STAT. §§ 807(F), 809(A) (1991 & Supp. 1996). Although the statute is unclear, it is not treated as an additional exemption. See Form 454-R-82 (Rev. 1986), State of Oklahoma Estate Tax Return.

155. See *supra* notes 143-44 and accompanying text.

156. The highest marginal tax bracket for property passing to the decedent's parents and descendants is 10%. 68 OKLA. STAT. § 803(1) (1991).

157. This is the tax which would be owing on a \$175,000 estate if there were no exemption. See *id.* The Oklahoma legislature should consider whether Congress was correct in determining that a credit is more equitable than an exemption. See *supra* notes 143-44 and accompanying text.

158. For example, with respect to a \$600,000 taxable estate passing to descendants, the federal marginal tax rate is 37% while the Oklahoma marginal tax rate is 7%. See I.R.C. § 2001(c) (1994); 68 OKLA. STAT. § 803(1) (1991).

159. This assumes that the estate does not qualify for the \$600,000 exemption. If the marital deduction was increased sufficiently to reduce the bypass gift to \$175,000, a decedent could avoid the payment of Oklahoma estate tax. Assume that a husband and wife each owned \$600,000 and that their estates never increased or decreased in size. If the husband died first and if he gave his property to his children, he would pay \$17,715 in Oklahoma estate tax but no federal tax. When the surviving spouse dies, she also would pay \$17,715 in Oklahoma estate tax and no federal tax. However, if the husband avoided the imposition of Oklahoma estate tax on his death by transferring \$425,000 to his spouse, her estate will pay \$163,250 in federal and \$47,600 in Oklahoma estate tax.

160. See *infra* notes 189-92 and accompanying text.

although the size of the exemption will probably play a major role in the debate.¹⁶¹

III. Proposals for Change

Prior to 1996, it had been nearly fifteen years since the Oklahoma legislature had made any significant changes to the Oklahoma estate tax.¹⁶² In 1996, the Oklahoma legislature liberalized the exclusion for decedents who owned qualifying family businesses and farms.¹⁶³ Even if one accepts the premise that the additional exclusion should be limited to a specific class of decedents, the statute is so poorly drafted that it will have to be amended in the future.¹⁶⁴

This portion of the article discusses approaches which the legislature might utilize to truly modernize the Oklahoma estate tax.

A. Pickup GST Tax

In 1986, Congress enacted the precursor to the current generation-skipping transfer (GST) tax provisions.¹⁶⁵ Congress believed that the federal transfer taxes should have a uniform effect, which is best served when tax consequences do not vary widely depending on whether property is passed to the next generation or in a manner which skips one or more generations.¹⁶⁶

The relevant provisions impose a separate GST tax on direct skips, taxable distributions, and taxable terminations.¹⁶⁷ The most common type of taxable transfer is a direct skip, which is a transfer to a "skip person" and subject to either federal gift or estate tax.¹⁶⁸ However, a transfer to a trust which is not a direct skip initially may give rise to a GST tax in the future, as the result of distributions to skip persons (taxable distributions), or the termination of certain interests in the trust (taxable terminations).¹⁶⁹

Taxable distributions and taxable terminations may occur as the result of an individual's death. The simplest example involves a trust which a parent establishes to pay the income to a child for life and then to distribute the assets to the child's descendants. The child's death results in a taxable termination and causes the imposition of GST tax. When there is a taxable distribution or taxable termination occurring at death, the federal provision authorizes a credit for GST tax actually paid to a state, not to exceed 5% of the federal GST tax.¹⁷⁰ In other

161. In fact, the legislature may decide to reduce the exemption to insure that the remaining changes are revenue neutral.

162. See *supra* notes 3-7 and accompanying text.

163. See *supra* notes 61-62 and accompanying text.

164. See *supra* notes 71-88 and accompanying text.

165. Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1431-1433, 100 Stat. 2085, 2717-32.

166. H.R. REP. NO. 99-426, at 824 (1986), reprinted in 1986-3 C.B. 824 (Vol. 2).

167. I.R.C. §§ 2611(a), 2612 (1994). The intricacies involving the imposition of the GST tax are outside the scope of this article.

168. *Id.* § 2611(c).

169. *Id.* § 2612(a), (b).

170. *Id.* § 2604.

words, to the extent that a state GST tax on taxable distributions and taxable terminations occurring at death does not exceed 5% of the federal tax, a state tax on these transfers does not result in the imposition of additional tax since it is offset by a corresponding reduction in the federal tax.¹⁷¹ Many states have enacted a GST tax which is linked to the available federal credit.¹⁷²

Oklahoma has not yet enacted a GST tax to take advantage of this unique form of federal revenue sharing. Although the tax would not raise a significant amount of revenue,¹⁷³ there is no justification for the legislature's failure to act.¹⁷⁴

171. This provision is similar to the credit for state death taxes for purposes of computing the federal estate tax. *See id.* § 2011.

172. *See, e.g.*, ARIZ. REV. STAT. ANN. § 42-1531 (1995); CAL. REV. & TAX. CODE § 16710 (West 1995); COLO. REV. STAT. § 39-23.5-106 (1995); FLA. STAT. ANN. §§ 198.021, 198.031 (West 1995); IDAHO CODE § 14-403 (1995); 35 ILL. ANN. STAT. 405/4 (Smith-Hurd 1995); IND. CODE ANN. § 6-4.1-11.5-8 (Burns 1995); IOWA CODE ANN. § 450A.2 (West 1995); KAN. STAT. ANN. § 79-1541a (1995); MD. CODE ANN., TAX-GEN. § 7-403 (1995); MASS. ANN. LAWS ch. 65C, § 4A (Law. Co-op. 1995); MO. REV. STAT. § 145.995 (1995); MONT. CODE ANN. § 72-16-1002 (1995); NEB. REV. STAT. § 77-2101.02 (1995); NEV. REV. STAT. § 375B.100 (1995); N.Y. TAX LAW §1022 (McKinney 1995); N.C. GEN. STAT. § 105-7.1 (1995); OHIO REV. CODE ANN. § 5731.18.1 (Anderson 1995); R.I. GEN. LAWS § 44-40-3 (1995); S.C. CODE ANN. § 12-16-720 (Law Co-op 1995); TENN. CODE ANN. § 67-8-603 (1995); TEX. TAX CODE ANN. § 211.054 (West 1995); VA. CODE ANN. § 58.1-936 (Michie 1995); WASH. REV. CODE § 83.100.045 (1995).

173. Every individual receives an exemption which permits them to transfer \$1,000,000 to skip persons without incurring federal GST tax. I.R.C. § 2631(a) (1994). If the individual or the personal representatives fail to allocate this exemption against specific transfers, the statute provides deemed allocation rules. *Id.* § 2632. In addition, the credit for state GST taxes is only available for certain types of taxable transfers. *See supra* note 170 and accompanying text.

174. The cost of collecting this additional revenue would be minimal. The Oklahoma Tax Commission could merely require the filing of the relevant federal forms. The legislature can appropriate a similar provision enacted by another state. Ohio has a particularly well-drafted provision:

5731.181 GENERATION-SKIPPING TRANSFERS

(A) For purposes of this section, "generation-skipping transfer," "taxable distribution," and "taxable termination" have the same meaning as in Chapter 13 of subtitle B of the Internal Revenue Code of 1986, 100 Stat. 2718, 26 U.S.C. 2601-2624, as amended.

(B) A tax is hereby levied upon every generation-skipping transfer of property having a situs in this state, that occurs at the same time as, and as a result of, the death of an individual, in an amount equal to the credit allowed by Chapter 13 of subtitle B of the Internal Revenue Code of 1986, 100 Stat. 2718, 26 U.S.C. 2601-2624, as amended, for any taxes paid to any state in respect of any property included in the generation-skipping transfer.

For purposes of this division, "property having a situs in this state" includes all the following:

- (1) Real property situated in this state;
- (2) Tangible personal property having an actual situs in this state;
- (3) Intangible personal property employed in carrying on a business in this state;
- (4) Intangible personal property owned by a trust, the trustee of which resides in or has its principal place of business in this state, or, if there is more than one trustee of the trust, the principal place of administration of which is in this state.

(C) The return with respect to the generation-skipping tax levied by division (B) of this section shall be filed in the form that the tax commissioner shall prescribe, on or before the day prescribed by law, including extensions, for filing the generation-skipping transfer tax return under Chapter 13 of subtitle B of the Internal Revenue Code of 1986, 100 Stat.

B. Pickup Estate Tax

An estate receives a credit against its federal estate tax for death tax paid to a state.¹⁷⁵ However, the credit is limited to an amount computed in accordance with the federal provision.¹⁷⁶ The majority of states have enacted only a tax which is equal to the federal credit for the state death tax.¹⁷⁷ The imposition of a pickup tax does not increase an estate's tax burden since the estate otherwise would be obligated to pay additional federal estate tax.¹⁷⁸

Oklahoma's estate tax accounts for only a small portion of the state's total revenue. During fiscal year 1992, Oklahoma collected \$47,777,650 in estate taxes, which comprised approximately 1.2% of the state's total revenue.¹⁷⁹ During that same year, the Oklahoma Tax Commission processed approximately 4400 estate tax returns.¹⁸⁰ In contrast, 540 federal estate tax returns for Oklahoma residents were filed in 1992, and 593 were filed in 1993.¹⁸¹ During 1992, the federal government collected \$70,390,000 from estates of Oklahoma residents, and during 1993, it collected \$53,090,000.¹⁸²

In this increasingly competitive economic environment, Oklahoma has recognized the importance of keeping its citizens from seeking other more financially advantageous states in which to reside. One of the key factors in increasing the

2718, 26 U.S.C. 2601-2624, as amended, for the same generation-skipping transfer. The return shall be filed by the distributee in the case of a taxable distribution and by the trustee in the case of a taxable termination.

(D) The generation-skipping tax levied by division (B) of this section shall be paid, without notice or demand by the tax commissioner, with the return, and shall be charged, collected, and administered in the same manner as estate taxes levied by this chapter. This chapter is generally applicable to, except to the extent it is inconsistent with the nature of, the generation-skipping tax.

(E) If another state levies a generation-skipping tax on a transfer described in division (B) of this section, the tax commissioner may enter into a compromise of the generation-skipping tax levied by division (B) of this section in the manner provided in section 5731.35 of the Revised Code, except that no approval of any probate court is required. If such a compromise agreement is made, no interest and penalties shall accrue for the period prior to the execution of the agreement and for sixty days after its execution.

OHIO REV. CODE ANN. § 5731.181 (Anderson 1996).

175. I.R.C. § 2011 (1994).

176. *Id.* § 2011(b).

177. *See supra* note 57 and accompanying text. In the event that the Oklahoma estate tax is less than the available federal credit, Oklahoma imposes an additional tax to absorb the federal credit. 68 OKLA. STAT. § 804 (Supp. 1996).

178. *See supra* notes 170-71 and accompanying text as the discussion relates to the GST tax.

179. CENTER FOR ECON. & MANAGEMENT RESEARCH, COLLEGE OF BUS. ADMIN., UNIV. OF OKLA. & OKLA. DEPT OF COMMERCE, STATISTICAL ABSTRACT OF OKLAHOMA 1993 182 (1993). For the fiscal year ending June 30, 1992, Oklahoma collected \$3,996,269,017 in total revenue.

180. H.R. 2209 Fiscal Impact Report, 43d Okla. Leg. (Mar. 3, 1992) ("Projected Taxable Estates") (on file with the *Oklahoma Law Review*).

181. U.S. Dep't of the Treasury, Internal Revenue Serv., *Estate Tax Returns, 1992-1993*, STAT. OF INCOME BULL., Spring 1995, at 114.

182. *Id.*

number of retired Oklahomans is the implementation of favorable tax laws. Over the past several years, many bills which would have given preferential tax treatment to retired residents have been introduced in the Oklahoma legislature.¹⁸³

Since 1980, Oklahoma has exempted from income taxation the first \$4000 of government retirement benefits.¹⁸⁴ In 1993, six bills were introduced which would have liberalized the provision.¹⁸⁵ In 1994, a bill was introduced which would have extended the applicability of the provision to all retirees.¹⁸⁶ Between 1995 and 1996, nine more proposals were introduced.¹⁸⁷ Finally, on May 23, 1996, Governor Frank Keating signed into law House Bill 1621, which extended the \$5500 exemption to benefits for private retirees whose Oklahoma adjusted gross income is \$25,000 or less for single filers and \$50,000 or less for joint filers.¹⁸⁸

Significant changes also have been considered with respect to the Oklahoma estate tax. Bills proposing the enactment of a pickup tax were introduced in 1992, 1994, 1995, and 1996.¹⁸⁹ Representative Frank W. Davis proposed the 1996 legislation, which is similar to the other bills.¹⁹⁰ Besides making numerous other

183. Property tax reform has garnered recent attention. Between 1995 and 1996, eight bills were introduced, addressing everything from changes in the homestead exemption to modifying assessment percentages. S. 20, 45th Leg., 1st Sess. (Okla. 1995); S. 21, 45th Leg., 1st Sess. (Okla. 1995); H.R.J. Res. 1035, 45th Leg., 1st Sess. (Okla. 1995); H.R. 2198, 45th Leg., 2d Sess. (Okla. 1996); H.R. 2151, 45th Leg., 2d Sess. (Okla. 1996); H.R. 2282, 45th Leg., 2d Sess. (Okla. 1996); H.R. 2299, 45th Leg., 2d Sess. (Okla. 1996); H.R. 2912, 45th Leg., 2d Sess. (Okla. 1996). The only one which became law increased the maximum gross household income allowed to qualify for an additional homestead exemption from \$10,000 to \$15,000. S. 681, 45th Leg., 2d Sess. (Okla. 1996) (signed into law by Governor Frank Keating on June 13, 1996). Since the provision applies to all low income taxpayers, it should not be viewed as a tax break which targets only the elderly.

184. Act of June 25, 1980, ch. 351, § 1, 1980 Okla. Sess. Laws 1026, 1033. The exemption was increased to \$5500 in 1989. Act of May 19, 1989, ch. 249, § 39, 1989 Okla. Sess. Laws 711, 766. The original provision was limited to civil servants of the United States. Between 1980 and 1996, it has been amended to embrace virtually all public employees. See 68 OKLA. STAT. § 2358(D)(9) (Supp. 1995).

185. H.R. 1285, 44th Leg., 1st Sess. (Okla. 1993); H.R. 1299, 44th Leg., 1st Sess. (Okla. 1993); H.R. 1311, 44th Leg., 1st Sess. (Okla. 1993); H.R. 1369, 44th Leg., 1st Sess. (Okla. 1993); H.R. 1713, 44th Leg., 1st Sess. (Okla. 1993); H.R. 1797, 44th Leg., 1st Sess. (Okla. 1993). None of these bills was enacted.

186. H.R. 1840, 44th Leg., 2d Sess. (Okla. 1994). Like the previous bills, H.R. 1840 died in the House Revenue and Taxation Committee.

187. S. 105, 45th Leg., 1st Sess. (Okla. 1995); H.R. 1019, 45th Leg., 1st Sess. (Okla. 1995); H.R. 2032, 45th Leg., 1st Sess. (Okla. 1995); H.R. 1896, 45th Leg., 1st Sess. (Okla. 1995) (reintroduced 45th Leg., 2d Sess. (Okla. 1995)); H.R. 1621, 45th Leg., 1st Sess. (Okla. 1995); H.R. 1386, 45th Leg., 1st Sess. (Okla. 1995); H.R. 2173, 45th Leg., 2d Sess. (Okla. 1996); H.R. 2221, 45th Leg., 2d Sess. (Okla. 1996); H.R. 2524, 45th Leg., 2d Sess. (Okla. 1996).

188. Act of May 23, 1996, ch. 216, § 1, 1996 Okla. Sess. Laws 836, 845 (West) (adding 68 OKLA. STAT. § 2358(D)(13) (Supp. 1996)). This provision phases in over a five-year period beginning in 1997 and does not replace the previous exemption relating to government employees. However, a government employee cannot claim a total exemption for retirement benefits in excess of \$5500. 68 OKLA. STAT. § 2358(D)(13)(F) (Supp. 1996).

189. H.R. 2209, 43d Leg., 2d Sess. (Okla. 1992); H.R. 2062, 44th Leg., 2d Sess. (Okla. 1994); S. 106, 45th Leg., 1st Sess. (Okla. 1995); H.R. 2618, 45th Leg., 2d Sess. (Okla. 1996).

190. See H.R. 2618, 45th Leg., 2d Sess. (Okla. 1996). This bill was named the Oklahoma Estate Tax

changes,¹⁹¹ the Simplification Act imposed a pickup tax on decedents dying after June 30, 2005.¹⁹² These proposals all died in committee.

For three of these bills, the Oklahoma Tax Commission prepared revenue impact statements.¹⁹³ When the pickup tax was fully phased in, the Tax Commission projected an annual revenue loss of approximately \$40,000,000, or 70% of the revenue which the current estate tax generates.¹⁹⁴ Both the 1994 and 1992 impact statements indicated that other factors, including inflation, would serve to reduce the revenue loss, but the Tax Commission did not make an effort to further identify or quantify these considerations.¹⁹⁵

The impact statements focus solely on revenue reduction, with all other factors remaining static. An obvious omission relates to the administrative savings which the Oklahoma Tax Commission would realize. First of all, the number of returns would decrease by over 85%.¹⁹⁶ In addition, most states that have enacted a pickup tax rely exclusively on the federal return and audit procedure to determine the size of the taxable estate and thus the amount of the state death tax credit.¹⁹⁷ If Oklahoma were to enact a pickup tax, it could dismantle the Estate Tax Section of the Tax Commission, realizing a savings which is not reflected in the revenue impact statements and achieving the popular goal of reducing the size of government.¹⁹⁸

Furthermore, the loss of future estate tax revenue is not the only state revenue affected. The current Oklahoma estate tax acts as an incentive for wealthy residents to retire in another state and as a disincentive for nonresidents to retire

Simplification Act of 1996 [hereinafter Simplification Act].

191. For example, the Simplification Act would have repealed all of the current Oklahoma estate tax provisions, including those relating to filing requirements, tax liens, and the other procedural aspects of collecting the tax. *See* Okla. H.R. 2618, § 20. The administrative provisions of the Simplification Act are outside the scope of this article.

192. *Id.* § 5. During the intervening years, the Oklahoma exemption would have increased to \$600,000. *Id.* § 11.

193. S. 106, 45th Leg., 1st Sess. (Okla. 1995), Fiscal Impact Statement, Feb. 2, 1995; H.R. 2062, 44th Leg., 2d Sess. (Okla. 1994), Fiscal Impact Report, July 20, 1994; H.R. 2209, 43d Leg., 2d Sess. (Okla. 1992), Fiscal Impact Report, March 3, 1992.

194. With respect to the 1995 legislation, the annual loss was estimated to be \$39,375,000. S. 106, 45th Leg., 1st Sess. (Okla. 1995), Fiscal Impact Statement, Feb. 2, 1995. With respect to the 1994 legislation, the annual loss was estimated to be \$43,790,000, while the expected revenue was \$59,972,000. H.R. 2062, 44th Leg., 2d Sess. (Okla. 1994), Fiscal Impact Report, July 20, 1994. With respect to the 1992 legislation, the annual loss was estimated to be \$37,000,000, while the expected revenue was \$53,600,000. H.R. 2209, 43d Leg., 2d Sess. (Okla. 1992), Fiscal Impact Report, Mar. 3, 1992.

195. H.R. 2062, 44th Leg., 2d Sess. (Okla. 1994), Fiscal Impact Report, July 20, 1994; H.R. 2209, 43d Leg., 2d Sess. (Okla. 1992), Fiscal Impact Report, March 3, 1992.

196. *See supra* notes 180-81 and accompanying text.

197. The state death tax credit is based on the federal taxable estate. I.R.C. § 2011(b) (1994). Thus, the interests of the federal government in the compliance process mirror the interests of those states which have enacted a pickup tax since an increase in the taxable estate increases both the federal estate tax and state death tax.

198. It also achieves the more popular goal of decreasing the size of the tax compliance division of state government.

in Oklahoma. The resulting reduction in the number of Oklahoma taxpayers affects income, sales, and property tax revenues, as well as receipts from gas, alcohol, and cigarette taxes. The overall state economy also suffers.

Arkansas, Colorado, Missouri, New Mexico, and Texas impose a death tax equal to the federal credit for state death taxes.¹⁹⁹ Of the states that border Oklahoma, only Kansas has failed to enact a pickup tax.²⁰⁰ It is impossible to determine the precise effect of the Oklahoma estate tax on the state's population. However, there are statistics available relating to migration patterns.

Between 1985 and 1990, the United States Bureau of the Census estimates that 127,760 more residents left Oklahoma than migrated to Oklahoma, which reflects approximately 4% of its population.²⁰¹ On a percentage basis, this was the highest loss in our seven-state region.²⁰² This is confirmed by statistics from the Internal Revenue Service. Between 1993 and 1994, the Service reports that taxpayers filing 39,338 individual income tax returns accounting for 85,234 exemptions left the state of Oklahoma.²⁰³ Over 25% of these taxpayers moved to Texas, and over 43% moved to those states which border Oklahoma and which impose a pickup tax.²⁰⁴

In 1994, the Census Bureau estimated that 13.6% of Oklahoma's population was age sixty-five or over.²⁰⁵ Furthermore, the number of Oklahoma residents over age sixty-five increased 4.7% between 1990 and 1994, but the average increase nationwide was 6.7%.²⁰⁶ Although the migration studies fail to estimate the number of Oklahoma's out-migrants who are retired, it is apparent that at least a portion of Oklahoma's retired work force is moving out of state. A change in the estate tax structure would encourage individuals to remain in Oklahoma.

Recently, numerous states have become aware of the increasing economic importance of the graying of America's population.²⁰⁷ South Carolina and Mas-

199. ARK. CODE ANN. §§ 26-59-101 to -122 (Michie 1987 & Supp. 1996); COLO. REV. STAT. §§ 39-23.5-101 to -117 (1994); MO. ANN. STAT. §§ 145.009-.985 (West 1996); N.M. STAT. ANN. §§ 7-7-1 to -7-20 (Michie 1996); TEX. TAX CODE ANN. §§ 211.001-.301 (West 1992 & Supp. 1996).

200. KAN. STAT. ANN. §§ 79-1501 to -1587 (1989 & Supp. 1995).

201. U.S. Bureau of the Census, *Immigrants, Outmigrants, and Net Migration Between 1985 and 1990 and Movers From Abroad, For States: 1990* (visited Oct. 1, 1996) <<http://www.census.gov/population/socdemo/migration/net-mig.txt>>.

202. While Texas lost more total residents, the loss accounted for only 2% of its 1985 population. As a comparison, Florida, which is considered a retirement haven, reported net in-migration for the same period of 1,071,682 which represented a 9% gain over its 1985 population. *Id.*

203. *1993-1994 State Outmigrant/Inmigrant Flow Data*, provided by Emily Gross, Internal Revenue Service, Statistics of Income Division, June 13, 1996.

204. *Id.* Texas received 25.7% of the out-migrants, Arkansas received 7.4%, Kansas received 6.2%, Missouri received 5.6%, Colorado received 3.5%, and New Mexico received 1.6%.

205. AMERICAN ASS'N OF RETIRED PERSONS & U.S. DEPT OF HEALTH AND HUMAN SERVS., *A PROFILE OF OLDER AMERICANS: 1995*, at 5 (1995).

206. *Id.*

207. Individuals over age sixty-five represented 13% of the population in 1990, but they will account for 20% by 2030. *Id.* at 2. Between 1960 and 1994 the entire United States population grew 45%, while the elderly population rose 100%. In 1995, a 65-year-old person can look forward to seventeen more spending years. *Id.* at 1.

sachusetts have made concerted efforts to increase their elderly population. One key incentive was the revamping of their estate tax systems. Both states commissioned detailed studies on the overall economic impact of a pickup tax,²⁰⁸ and these studies convinced the respective legislatures to repeal their existing estate taxes.²⁰⁹

South Carolina desired to encourage the migration of wealthy individuals into the state. South Carolina was particularly sensitive to regional factors since it was in direct competition with other southern states for America's retirement dollars. Similar to Oklahoma, South Carolina was at a competitive disadvantage since only one other state in its region had failed to enact a pickup tax.²¹⁰

The Pugh Report determined that the average size of South Carolina's gross estate had been lower than the national average in 1977 and 1983, but had increased by 1984.²¹¹ The authors viewed this as a favorable indicator of the state's ability to attract wealthy residents. Oklahoma demonstrates the same trend. In 1992, Oklahoma's average gross estate was 22.15% below the national average, but it was only 13.50% below in 1993.²¹²

South Carolina also was concerned that only 1% of the top wealth holders in the United States lived in the state in 1982, while its population represented 1.3% of the total.²¹³ In fact, South Carolina's percentage of top wealth holders was decreasing.²¹⁴ A change in this trend occurred after 1986, the date of the Pugh Report. In 1989, after South Carolina enacted the pickup tax, its top wealth

208. See OLIN S. PUGH & HARRY W. MILEY, SOUTH CAROLINA LAW INST., AN ECONOMIC ANALYSIS OF A PROPOSAL TO HAVE SOUTH CAROLINA'S ESTATE TAX CONFORM WITH THE FEDERAL TAX CREDIT (1986) [hereinafter PUGH REPORT]; WILLIAM H. CROWN & THOMAS D. LEAVITT, BOSTON ESTATE PLANNING COUNCIL, THE IMPACT OF ESTATE TAX REFORM ON MASSACHUSETTS TAX RECEIPTS (1991) [hereinafter CROWN REPORT].

209. See S.C. CODE ANN. §§ 12-16-10 to -16-150 (Law. Co-op. Supp. 1995) (effective for decedents dying after June 30, 1991); MASS. ANN. LAWS ch. 65C, § 2A (Law. Co-op. 1991 & Supp. 1996) (effective for decedents dying after 1996).

210. Of the five states considered — Virginia, Georgia, Florida, Alabama, and North Carolina — only North Carolina did not have a pickup tax. However, North Carolina had recently reduced its effective rates. See PUGH REPORT, *supra* note 208, at 10.

211. *Id.* at 15. From being 11.14% and 18.54% lower in 1977 and 1983 respectively, South Carolina's average gross estate had jumped to being 42.43% above the national average in 1984.

212. See EDWIN R. BYERLY & KEVIN DEARDORFF, U.S. BUREAU OF THE CENSUS, NATIONAL AND STATE POPULATION ESTIMATES: 1990-1994, at 10-12 (1995); Barry W. Johnson, U.S. Internal Revenue Serv., *Estate Tax Returns, 1992-93*, STAT. OF INCOME BULL., Spring 1995, at 101. Regionally for 1993, only Colorado had a lower average gross estate than Oklahoma, and only New Mexico was above average. Colorado was 15.20% below the national average, Kansas was 8.76% below, Missouri was 7.57% below, and Texas was 4.84% below. New Mexico was 11.51% above. The 1993 Arkansas data were not included in the comparison. Due to the filing of the estate tax return for Sam Walton, the Arkansas average was 435.10% above the national average. *Id.*; see also *What We Can Learn from Sam and Helen Walton?*, TR. & EST., Aug. 1995, at 60.

213. PUGH REPORT, *supra* note 208, at 23.

214. In 1976, South Carolina was 25.30% below the national average, in 1982 it was 30.88% below, and in 1986 it was 36.50% below. See *id.*; Marvin Schwartz & Barry Johnson, U.S. Internal Revenue Serv., *Estimates of Personal Wealth, 1986*, STAT. OF INCOME BULL., Spring 1990, at 63; U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 22 (1988).

holders had increased so that the state was only 13.07% below the national average, a 23% gain from 1986.²¹⁵

The authors of the Pugh Report acknowledged that a short-term estate tax revenue loss would occur, but focused on other revenue sources, including increased income, sales, and property taxes. Their estimates showed that South Carolina would realize an additional \$16,450,000 of increased revenue from these sources if an additional 1000 high-income families migrated into the state.²¹⁶ In future years, these residents would also contribute to increased pickup tax collections which would help offset the reduction in estate tax revenues. The Pugh Report also concluded that making the estate tax laws more attractive would complement other economic and development policies designed to improve the state's overall growth, and the importation of capital into the state would increase construction and development, thus creating new jobs.²¹⁷ Although the authors stopped short of concluding that these other revenue sources would offset the loss in estate tax revenue, they did conclude that favorable revenue impacts could be expected within two years of enacting a pickup tax, and that phasing in that tax would minimize the damage to the state fisc.²¹⁸

Massachusetts faced a somewhat different situation. Like other northeastern states, it had a relatively aggressive income tax.²¹⁹ As a result, its older residents were migrating to warmer, tax haven states such as Florida, and some younger individuals who worked in Massachusetts chose to live in adjacent states and commute. Although Massachusetts was concerned with in-migration, it was principally concerned with keeping its wealthy retirees from migrating out of state.

The Massachusetts legislature commissioned a study to estimate total revenue loss associated with wealthy individuals retiring in other states.²²⁰ The authors of the Crown Report developed a statistical migration model to determine the impact of enacting a pickup tax.²²¹ Their analysis focused on the age, race, and

215. See U.S. Internal Revenue Serv., *Estimates of Personal Wealth, 1989*, STAT. OF INCOME BULL., Spring 1993, at 105; U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 23 (1991).

216. PUGH REPORT, *supra* note 208, at 41. The target group is based on individuals with incomes of at least \$50,000 and net worth of at least \$250,000. *Id.*

217. *Id.* Besides making changes to the estate tax, South Carolina was making an effort to increase recreation, cultural, educational, and medical services.

218. *Id.* at 42. South Carolina elected to postpone the effective date of the pickup tax for four years. See S.C. CODE ANN. § 12-16-510 (Law. Co-op. 1988 & Supp. 1995).

219. Massachusetts imposes a flat 12% tax on investment income. MASS. ANN. LAWS ch. 62, § 4(a) (Law. Co-op. Supp. 1996). The comparable top rate in Oklahoma is 10% on income in excess of \$24,000 if taxpayers elect to deduct the federal income tax and 7% on income in excess of \$21,000 if taxpayers elect not to claim a deduction for federal income tax. 68 OKLA. STAT. § 2355 (1991).

220. See CROWN REPORT, *supra* note 208.

221. See *id.* at 11-18. The statistical model was based on population characteristics from the Current Population Survey (CPS) and employment, economic, and asset information from the Survey of Income and Program Participation (SIPP). The various findings were based on estimates of the change in probabilities of migrating by income and asset categories, determined through regression analysis.

marital status of the out-migrants and the characteristics of the states involved in the interstate move, including the estate tax structure and the distance between the origin and destination states.²²²

The Crown Report concluded that the distribution of wealth is very highly skewed. As a result, a relatively small migration of very affluent residents could have substantial effects on estate tax revenues. In 1986, the number of Massachusetts' top wealth holders were 41.66% above the national average. However, this advantage had dropped to only 35.13% by 1989.²²³ Similarly, Massachusetts residents with gross assets between \$600,000 and \$1 million accounted for 3.22% of all of the country's top wealth holders in 1989, while the state had only 2.38% of the total population.²²⁴ Based on the 1990 census, 13.58% of the state's top wealth holders were age sixty-five or over.²²⁵

The authors first looked at elderly demographics. At the time of the report, 64% of interstate migrants were married, and 68% were age sixty-five or over.²²⁶ Married migrants were over twice as likely as unmarried migrants to have incomes over \$30,000, and 3.6% of married migrants had assets over \$400,000.²²⁷ The Crown Report found that 60% of all interstate moves by the elderly were to sunbelt states, with 70% of the married migrants and 40% of the unmarried migrants choosing those states.²²⁸

If Massachusetts were to enact a pickup tax, the estate tax revenue loss for 1987 was estimated to be \$160.56 million.²²⁹ The authors then analyzed two statistical models to determine the corresponding effect on income, sales, alcohol, cigarette, and gasoline taxes, as well as future pickup taxes.²³⁰ Under the first approach, the adoption of a pickup tax would result in a net revenue gain of \$82,790,000.²³¹ The second analysis suggested that the state would realize a gain of \$249,330,000.²³² In other words, the Crown Report concluded that the state of Massachusetts would have additional revenues if it were to enact a pickup tax.

222. *Id.* at 16. The authors elected to ignore state income taxes, temperature, and climate of Massachusetts and the destination states because they believed those factors were not statistically significant. An uninformed observer might question the importance of a warm, income-tax-free climate such as Florida to retirees.

223. *Id.*

224. *Id.*

225. See BYERLY & DEARDORF, note 212, at 5.

226. CROWN REPORT, *supra* note 208, at 13.

227. *Id.* at 14. In comparison, only 1.2% of unmarried individuals had assets over \$400,000. *Id.*

228. *Id.* at 15. The five most common destinations were Florida (17%), Arizona (11%), Texas (8%), Missouri (5%), and Ohio (5%).

229. *Id.* at 25. This amounts to a 72% decrease in estate tax revenues. *Id.* at 21.

230. *Id.* at 25. Although the estate tax revenue effects would not be felt for some time, the non-migrants will affect other tax revenues in every year of their remaining life expectancy.

231. *Id.* Using the present value approach, the net revenue in current dollars would be a loss of \$17.5 million.

232. *Id.* at 30. Even after applying the present value formula, there would be a net gain in revenues of \$86.27 million. *Id.* at 31.

The authors also concluded that the adoption of a pickup tax would be revenue neutral if only 161 individuals in the target group decided not to migrate because of the change.²³³ Similar results might be obtainable in Oklahoma.²³⁴ Unlike Massachusetts, Oklahoma has the additional possibility of convincing higher income individuals from other states to retire in Oklahoma.²³⁵

Although it is impossible to determine the precise revenue effect of enacting a pickup tax, it is evident that the financial analysis must include expected cost savings and the possibility of additional income, sales, property, and excise tax revenues. It may be unlikely that Oklahoma would enjoy a net revenue increase as predicted for Massachusetts. However, it is clear that the dire revenue projections prepared in the past overstate the actual loss which the state would incur.

There is another reason why Oklahoma should consider a pickup tax. Under the current estate tax, all estates must file a return.²³⁶ This results in increased administrative costs in connection with processing the returns²³⁷ and places a significant compliance burden on all estates, causing a disproportionate expense to small estates.

The enactment of a pickup tax would create a simple and equitable system of estate taxation which would benefit all Oklahomans. It would also bring Oklahoma in line with the majority of other states.²³⁸

233. *Id.* at 37.

234. Since the number of Oklahomans over age 65 is increasing at a much slower rate than the national average, it is clear that a relatively large number are electing to retire out of state. *See supra* notes 205-06 and accompanying text.

235. Obviously Oklahoma is not competing with Florida for the East Coast retirees. However, regionally, Oklahoma has a lot to offer those over age 65. The weather is mild enough to be considered part of the sunbelt, while not so overly hot and humid as to detract from the state's general appeal. Oklahoma has a fairly low crime rate and is well below the national average in violent crimes for 1993 and 1994. U.S. Bureau of the Census, 1995 Statistical Abstract of the United States, *Oklahoma State Profile* (last modified Mar. 7, 1996) <<http://www.census.gov/ftp/pub/statab/www/states/ok.txt>>.

236. Although there is a \$175,000 exemption for property passing to the decedent's parents and descendants, there is only a \$100 exemption for property passing to other beneficiaries. 68 OKLA. STAT. §§ 807(F), 809(A) (1991 & Supp. 1996). As a result, even a small estate which passes to the decedent's children must file a return to establish its entitlement to the increased exemption.

237. *See supra* notes 180-81 and accompanying text.

238. South Carolina has enacted a typical pickup tax provision. Although there are a number of administrative provisions which should be considered, the following provisions actually impose the tax on residents and nonresidents:

§ 12-16-510. Estates of residents.

(A) A tax in the amount of the Federal Credit is imposed on the transfer of the taxable Estate of every resident, subject, where applicable, to the credit provided in subsection (B).

(B) If any real and tangible personal property of a resident is located outside of this State and is subject to a death tax imposed by another state for which the Federal Credit is allowed, the amount of the tax due under this section must be credited with the lesser of:

(1) the amount of the death tax paid the other state and credited against the federal Estate tax; or

C. Conforming the Oklahoma Taxable Estate to the Federal

Even if the Oklahoma legislature is unwilling to enact a pickup tax, the Simplification Act proposed another major change which warrants serious consideration. As noted in the first part of this article, the definition of the Oklahoma taxable estate differs significantly from its federal counterpart. Most differences are traced directly to the dynamic nature of the federal estate tax as compared to the relatively static Oklahoma tax.²³⁹

Conforming the Oklahoma provisions to the federal would result in true tax simplification.²⁴⁰ Although many of the federal provisions are exceedingly complex, Oklahoma cannot insulate its residents from their application. However, the legislature can and should eliminate an attorney's burdensome responsibility to master two different sets of rules.²⁴¹ Furthermore, if the Oklahoma statute

(2) an amount computed by multiplying the Federal Credit by a fraction, the numerator of which is the value of that part of the gross Estate over which another state or states have jurisdiction to the same extent to which this State would exert jurisdiction under this chapter with respect to the residents of the other state or states and the denominator of which is the value of the decedent's gross Estate.

(C) Property of a resident includes:

(1) real property situated in this State;

(2) tangible personal property having an actual situs in this State; and

(3) intangible personal property owned by the resident regardless of where it is located.

S.C. CODE ANN. § 12-16-510 (Law. Co-op. 1976 & Supp. 1995).

§ 12-16-520. Estates of nonresidents.

(A) A tax in an amount computed as provided in this section is imposed on the transfer of every nonresident's taxable estate located in this State.

The tax is an amount computed by multiplying the federal credit by a fraction, the numerator of which is the value of that part of the gross Estate over which this State has jurisdiction for Estate tax purposes and the denominator of which is the value of the decedent's gross Estate.

(B) For purposes of this section, property located in this State which is taxable to a nonresident includes:

(1) real property and real property interests located in this State, including mineral interests, royalties, production payments, leasehold interests, or working interests in oil, gas, coal, or any other minerals; and

(2) tangible personal property having an actual situs in this State.

Id. § 12-16-520.

239. See *supra* notes 1-8 and accompanying text.

240. The change could be revenue neutral. Even though conforming the Oklahoma provisions would probably reduce revenue, the legislature could make offsetting adjustments in the exemption or tax rates. In 1992, legislation was introduced to first conform the Oklahoma and federal definitions and to then phase in a pickup tax. See H.R. 2209, 43d Leg., 2d Sess. (Okla. 1992). The bill would have been revenue neutral in the first year. See Fiscal Impact Report, House Fiscal Division (Mar. 3, 1992).

241. The author challenges any member of the legislature to adequately explain the following exclusion from the Oklahoma gross estate:

This article shall not include as a taxable asset any interest in any policy or contract of insurance, wherein the insured survives such spouse or beneficiary, belonging to any deceased spouse as such, or to any deceased spouse as beneficiary, or to any deceased beneficiary, claimed or existing on account of payment of premiums from funds of any beneficiary.

referenced the federal taxable estate, it would necessarily incorporate federal provisions such as the special use valuation and QTIP marital deduction.²⁴² There already has been a national debate with respect to the merits of these provisions, and it seems unnecessary to duplicate that discussion in Oklahoma.

The definition of the Oklahoma taxable estate also should embrace future amendments to the federal statute. It would be difficult for the legislature to pass state legislation quickly enough to track the mercurial nature of the Internal Revenue Code.²⁴³ It also would empower the Oklahoma legislature to test the political winds before enacting federal changes, a dangerous practice which, over time, could produce significant differences between the federal and Oklahoma provisions. Finally, Oklahoma practitioners might be hesitant to exploit estate planning alternatives sanctioned by recent federal amendments until the Oklahoma legislature acts.

Currently, the taxable estate²⁴⁴ is equal to the Oklahoma gross estate less deductions and the allowable exemption.²⁴⁵ The Simplification Act proposed to repeal these lengthy sections, defining the Oklahoma taxable estate as follows:

For purposes of the Oklahoma Estate Tax Simplification Act of 1995, the gross estate of a decedent shall be the same as defined in the provisions of the Internal Revenue Code and the value of the net

68 OKLA. STAT. § 807(A)(6)(b) (1991).

242. The federal gross estate reflects the reduced value of property the estate has elected to specially value pursuant to I.R.C. § 2032A. *See supra* notes 55-58. Similarly, the federal taxable estate reflects property with respect to which the estate has made a QTIP election. *See supra* notes 24-27 and accompanying text.

243. There are several recent estate tax examples. In 1976, Congress determined that beneficiaries acquiring assets from a decedent dying after 1976 would generally receive a carryover basis in the property rather than basis equal to the property's fair market value at the decedent's death. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1872-79. In 1978, its effective date was postponed until December 31, 1979, and in 1980, it was repealed retroactively. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, 2884; Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, 94 Stat. 229, 299-01.

In 1987, Congress enacted a provision designed to combat estate freezes. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, 1330-431 to -432 (adding I.R.C. 2036(c)). In 1990, that ill-conceived effort was also repealed retroactively. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, 1388-490 to -491. However, it was replaced by I.R.C. §§ 2701-2704 (1994) (added by Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388, 1388-491 to -501).

In 1986, Congress continued its infatuation with employee stock ownership plans by creating an estate tax deduction equal to 50% of the proceeds of qualified sales of employer securities. *See Tax Reform Act of 1986*, Pub. L. No. 99-514, 100 Stat. 2085, 2513-15 (adding I.R.C. § 2057). Three years later, Congress changed its mind. Section 2057 was repealed for decedents dying after July 12, 1989. Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106, 2352-54.

244. The Oklahoma statute imposes a tax on the "net estate," while the federal tax is imposed on the "taxable estate." *Compare* 68 OKLA. STAT. §§ 803, 808 (1991) *with* I.R.C. §§ 2001(a), 2051 (1994).

245. For property passing to beneficiaries other than the decedent's parents and descendants, the exemption is \$100. 68 OKLA. STAT. § 807(F) (1991). For property passing to the decedent's parents and descendants, the exemption is \$175,000, unless it comprises qualifying businesses and farms, in which case the exemption can increase to \$600,000. 68 OKLA. STAT. § 809 (Supp. 1996).

estate and transfers shall be determined as provided for in the Internal Revenue Code and the applicable federal rules and regulations.²⁴⁶

Although this simplistic approach would be easy to administer, the legislature should make several modifications to preserve the integrity of the Oklahoma estate tax and to insure that certain elections are available to smaller estates.

Gifts made within three years of death are generally excluded from the federal gross estate.²⁴⁷ Since Oklahoma does not have a gift tax, a person could reduce the state tax burden by making deathbed transfers without incurring additional federal transfer tax liability.²⁴⁸ Oklahoma should adjust the federal taxable estate by adding all gifts made within three years of death which are not otherwise included in the federal gross estate, regardless of the decedent's intent.²⁴⁹ The transfer generally should be valued as of the date of death (or, if elected, the alternate valuation date).²⁵⁰ This adjustment would subject those gifts to Oklahoma estate tax on the decedent's death.²⁵¹ The legislature should exclude from this rule's application gifts which qualify for the gift tax annual exclusion and qualified transfers for educational or medical purposes.²⁵²

Oklahoma's adoption of a QTIP marital deduction causes additional complexity. If the first spouse receives a marital deduction for QTIP property, the full value of that property must be included in the surviving spouse's federal gross estate.²⁵³ If both spouses died residents of Oklahoma and if the election covered property subject to tax in Oklahoma, the value of the QTIP property should be included in the survivor's estate. Since this property is included in the federal gross estate, no adjustment to the federal taxable estate is required to obtain this result.²⁵⁴

246. Oklahoma Estate Tax Simplification Act of 1996, § 12, H.R. 2618, 45th Leg., 2d Sess (Okla. 1996). The Simplification Act incorrectly referenced the federal net estate rather than the taxable estate.

247. I.R.C. § 2035(d)(1) (1994).

248. See *supra* notes 131-32 and accompanying text. Since a donee receives a carryover basis in property, death bed transfers may result in additional income tax on the subsequent sale of appreciated property. Compare I.R.C. § 1014 (1994) with *id.* § 1015.

249. For a discussion with respect to the advantages of an irrebuttable presumption of inclusion, see *supra* notes 136-37 and accompanying text.

250. Under the federal rules, a gift made within three years of death and included in the gross estate pursuant to I.R.C. § 2035 is valued as of the date of death (or alternate valuation date), excluding any improvements which the donee made and any income which the property generated. Treas. Reg. § 20.2035-1(e) (1958). A similar approach is adopted by current 68 OKLA. STAT. § 807(A)(2) (1991).

251. Compare this with the federal unified gift and estate tax. For purposes of determining the federal estate tax, all adjusted taxable gifts (other than gifts included in the gross estate) are included in the tax base which taxes the decedent's estate at the higher marginal rate but does not result in those gifts being taxed twice. See I.R.C. § 2001(b) (1994).

252. See *id.* § 2035(b), (e). An additional issue arises with respect to gifts of real property and tangible personal property located outside Oklahoma. The presumption should apply to all gifts, regardless of the property's location. However, when calculating the fraction representing that portion of the decedent's estate taxable in Oklahoma, only property which otherwise would be subject to Oklahoma estate tax should be included in the numerator, while all gifts made within three years of death should be included in the denominator. See *infra* notes 285-92 and accompanying text.

253. I.R.C. § 2044 (1994).

254. The legislature should also include in the survivor's gross estate the value of QTIP property

It is possible that the first spouse did not receive the benefit of the marital deduction for Oklahoma estate tax purposes. For example, the QTIP election may have involved real property or tangible personal property located outside Oklahoma,²⁵⁵ or the first spouse may have been a nonresident, and the surviving spouse subsequently became an Oklahoma resident.²⁵⁶ In this instance, the legislature could exclude that QTIP property from the Oklahoma taxable estate.

Conversely, the first spouse may have received an Oklahoma marital deduction for QTIP property, and the second spouse may move out of state.²⁵⁷ The legislature may desire to subject the QTIP property to Oklahoma tax on the death of the survivor, even though that property is not real estate or tangible personal property located in Oklahoma and thus not otherwise subject to the Oklahoma estate tax.

The legislature should eschew these temptations. If property was subject to a QTIP election for federal estate tax purposes, the inclusion of that property in the survivor's estate for Oklahoma estate tax purposes should be determined by the same rules applied to property which the survivor owns outright. If the survivor is a resident of Oklahoma at the time of death, property subject to the QTIP election will be included in the Oklahoma taxable estate unless it comprises real property or tangible personal property located out of state. If the survivor is a nonresident, the QTIP property will be subject to Oklahoma tax only if it is real property or tangible personal property located within Oklahoma.²⁵⁸

This approach makes it easier to enforce the Oklahoma estate tax since it generally will attach to assets physically located within the state and subject to the court's jurisdiction. It may result in the first spouse receiving an Oklahoma marital deduction while the survivor will not be required to pay Oklahoma estate tax on that same property.²⁵⁹ However, this problem is not unique to QTIP property. If an Oklahoma resident makes a bequest of personal property to a surviving spouse who then changes residency, the property will escape Oklahoma taxation on the survivor's death.²⁶⁰

which qualified for the marital deduction in the first spouse's estate if the survivor disposes of all or part of the qualifying income interest within three years of death. *See id.* § 2519 (imposing a gift tax on these transfers).

255. *See infra* notes 290-92 and accompanying text.

256. This assumes that the original election did not involve real property or tangible personal property located in Oklahoma. If the estate of a nonresident makes an election with respect to real property located in Oklahoma, the estate does receive the benefit of the marital deduction for Oklahoma purposes, and it should be subject to Oklahoma tax on the death of the survivor. *See infra* notes 290-92 and accompanying text.

257. Alternatively, the election made by the estate of a nonresident could involve real property in Oklahoma, thus entitling the nonresident to a marital deduction for Oklahoma tax purposes. *See infra* notes 292-95 and accompanying text.

258. Other states which have enacted a QTIP deduction have adopted this same approach. *See N.Y. TAX LAW* § 954(a)(4) (McKinney 1996) (providing that the QTIP assets are included in the estate of the survivor if those assets previously qualified for a New York deduction).

259. Conversely, it may also mean that Oklahoma may tax property which did not previously give rise to a deduction in which the surviving spouse held only an income interest.

260. An issue remains with respect to the treatment of QTIP elections made under prior law. The Oklahoma statute permits an estate to deduct only the value of the income interest passing to the

An estate can elect to value assets as of the alternate valuation date only if the election decreases both the value of the gross estate and the amount of federal estate tax.²⁶¹ A federal return is required only if the gross estate (including adjusted taxable gifts) exceeds \$600,000.²⁶² Similarly, an estate can elect to claim a marital deduction for QTIP property only if it files a federal estate tax return.²⁶³ Oklahoma should authorize small estates to elect the alternate valuation date or to make QTIP elections if they otherwise would have qualified for the federal election. If a federal return is filed, the state elections should conform with the federal.²⁶⁴

There is less need to provide for the special use election for small estates. On a \$600,000 estate, Oklahoma currently imposes \$17,725 of estate tax.²⁶⁵ The tax relief which an Oklahoma special use election would provide for small estates is outweighed by the complexity of administering this election for only Oklahoma purposes.²⁶⁶ If an estate makes this election on the federal return, however, the special use value should also be used to determine the Oklahoma estate tax obligation.²⁶⁷

It may not be necessary to permit an estate to pay Oklahoma estate tax attributable to closely held business interests in installments at a preferential rate of interest²⁶⁸ or to defer the payment of estate tax attributable to reversionary and remainder interests.²⁶⁹ Since the Oklahoma tax burden is significantly less than the federal, this special form of tax relief may be unnecessary.²⁷⁰

surviving spouse and includes no portion of the QTIP in the survivor's estate. *See supra* notes 28-37 and accompanying text. This rule should continue to apply to QTIP elections made prior to the effective date of any new legislation.

261. I.R.C. § 2032(c) (1994).

262. *Id.* § 6018(a).

263. *Id.* § 2056(b)(7)(B)(v).

264. In other words, an estate could not make a state election if it chooses to forego the federal election, and it could not make a federal election and fail to make the corresponding state election. Requiring the state elections to conform with the federal would generally make it easier to administer the estate and to supervise the compliance process.

265. This assumes that conforming the Oklahoma and federal provisions would eliminate the increased Oklahoma exemption of qualifying family businesses and farms. This also assumes that the qualified property passes to the decedent's parents or descendants. 68 OKLA. STAT. § 803(1) (1991). The definition of qualified heirs for purposes of I.R.C. § 2032A is broader than those who qualify for preferential Oklahoma estate tax treatment. *Compare* I.R.C. § 2032A(e)(2) (1994) with 68 OKLA. STAT. §§ 803(1), 809(A) (1991 & Supp. 1996).

266. *See supra* note 93.

267. Assuming that a special use election resulted in the maximum reduction in value, that the property passed to descendants of the decedent's parents, and the taxable estate was in excess of \$1,000,000, the election could save \$112,500 of Oklahoma estate tax. *See* I.R.C. § 2032A(a)(2) (1994); 68 OKLA. STAT. § 803(2) (1991).

In the event the estate fails to maintain the qualified use for the statutory period, additional Oklahoma estate tax would be imposed. *See* I.R.C. § 2032A(c) (1994).

268. *See* I.R.C. § 6166 (1994).

269. *See id.* § 6163.

270. The highest federal marginal tax rate is 55%, while the top Oklahoma rate for property passing to the decedent's parents and descendants is 10%. *Compare id.* § 2001(c) with 68 OKLA. STAT. § 803(1) (1991).

The modifications required to insure that Oklahoma only imposes an estate tax on property subject to its jurisdiction are more complex. Based on a literal reading, the Simplification Act would tax in Oklahoma all property owned by a decedent, regardless of that decedent's residency.²⁷¹ This is an oversight. There are serious constitutional problems with respect to a state's attempt to impose a death tax on property physically located in other states.²⁷²

With respect to resident decedents, the current Oklahoma statute exempts from taxation real property and tangible personal property located outside Oklahoma.²⁷³ The statute also allows only those deductions attributable to property included in the Oklahoma gross estate. That portion allowed is equal to the total deductions (including the marital deduction and the \$175,000 exemption) times a fraction, the numerator of which is the value of the property included in the Oklahoma gross estate and the denominator of which is the value of the total gross estate, including property located outside its jurisdiction.²⁷⁴

For example, assume that a decedent died a resident of Oklahoma, survived only by a child who was the sole beneficiary. The gross estate is valued at \$1,000,000, which includes Texas real estate worth \$400,000. Also assume that there are \$300,000 of debts and administration deductions. The current Oklahoma estate tax is computed as follows:

Oklahoma gross estate		\$600,000
Deductions	\$300,000	
Exemption	<u>175,000</u>	
Total reductions	\$475,000	
Portion allocable to		
Texas real estate (40%)	<u>(190,000)</u>	
Allowable reductions		<u>285,000</u>
Oklahoma taxable estate		\$315,000
Tax on above amount		\$ 10,575

271. The Simplification Act would impose a tax "upon the transfer of the net estate of every decedent." Oklahoma Estate Tax Simplification Act of 1996, § 3, H.R. 2618, 45th Leg., 2d Sess (Okla. 1996). The Oklahoma taxable estate is determined as provided in the Internal Revenue Code. *Id.* § 11. The Simplification Act does not include any reference to nonresident decedents or to property located outside Oklahoma. However, the pickup tax (effective for decedents dying after July 1, 2001) would apply only to residents. *Id.* §§ 5-6.

272. A state's attempt to impose a death tax on tangible property located outside its jurisdiction violates the due process clause, U.S. CONST. amend. XIV, § 1. *See, e.g.,* Treichler v. Wisconsin, 338 U.S. 251, 257 (1949); Frick v. Pennsylvania, 268 U.S. 473, 492 (1939).

273. *See* 68 OKLA. STAT. § 807(A)(1), (7) (1991). The current statute makes no effort to define tangible personal property, and there is limited case law on point. *See* Estate of Shelton v. Oklahoma Tax Comm'n, 544 P.2d 495, 496 (Okla. 1975) (Indian head rights are an interest in realty and thus tangible); Perkins v. Oklahoma Tax Comm'n, 428 P.2d 328, 330-31 (Okla. 1967) (a partnership interest is intangible personal property). The legislature should consider clarifying this definition in any major revision of the Oklahoma estate tax.

274. *See* 68 OKLA. STAT. § 808 (1991); State of Oklahoma Estate Tax Return, Form 45-R-82 (Rev. 1986), lines 19-21.

Since Texas real estate comprised 40% of the gross estate, the statute disallows 40% of the deductions and exemption.²⁷⁵

The Oklahoma formula fails to include the Texas real estate in the tax base for purposes of applying the Oklahoma tax tables. As a result, the Oklahoma tax is computed using only the lower tax brackets. Alternatively, the legislature could provide that the Oklahoma estate tax be computed on the total gross estate (including real property and tangible personal property located in other states) and then determine the amount apportioned to Oklahoma by multiplying that result by the fraction representing Oklahoma property.²⁷⁶ Using this approach, the above estate would pay an additional \$4035 of Oklahoma estate tax:

Oklahoma gross estate		\$1,000,000
Deductions	\$300,000	
Exemption	<u>175,000</u>	
Allowable reductions		<u>475,000</u>
Taxable estate		\$ 525,000
Tax on above amount		\$ 24,350
Portion allocated to Oklahoma (60%)		\$ 14,610

The above calculation more equitably reflects the total wealth which the decedent is transmitting²⁷⁷ and parallels the approach adopted by those states which have enacted a pickup tax.²⁷⁸

There is an additional inequity which the Oklahoma legislature should address. Decedents receive a federal marital or charitable deduction with respect to all qualifying property, regardless of its location.²⁷⁹ In the above example, assume that all Oklahoma property passes to the surviving spouse, the Texas real estate passes to a child, and there are no other deductions. Even though Oklahoma has enacted an unlimited marital deduction²⁸⁰ and all property subject to estate tax in Oklahoma passes to the surviving spouse, under the formula advocated above, the estate will be required to pay nearly \$7000 in Oklahoma estate tax.²⁸¹

275. See 68 OKLA. STAT. § 808 (1991).

276. Two states impose an estate tax other than Oklahoma. New York has adopted the approach advocated above. See N.Y. TAX LAW § 952(a) (McKinney 1996). Ohio computes its tax in the same manner as the current Oklahoma method. See OHIO REV. CODE ANN. § 5731.02 (Anderson 1996) (where the statute, by inference, excludes property located outside Ohio from tax).

277. There seems little reason why a resident with \$1,000,000 in Oklahoma assets and significant out-of-state holdings should be taxed at the same marginal rate as a resident with \$1,000,000 in Oklahoma assets and no out-of-state holdings.

278. The pickup tax payable to the state of residency generally is equal to the federal credit for state death taxes times a fraction, the numerator of which is the value of the property located in the state of residency and the denominator of which is the value of the total gross estate. See *supra* note 238. Any other approach would not fully allocate the available credit between two states.

279. I.R.C. §§ 2055-2056 (1994).

280. 68 OKLA. STAT. § 807(B) (1991).

281. The computation is as follows:

The formula used to apportion a decedent's Oklahoma tax burden can address this concern.²⁸² To the extent a marital bequest can be satisfied with either Oklahoma or out-of-state property, the Oklahoma marital deduction should be denied.²⁸³ This prevents the estate from obtaining an Oklahoma marital deduction for out-of-state property which will not be subject to the Oklahoma estate tax on the spouse's death.²⁸⁴

If the legislature conforms the Oklahoma and federal definitions, the adjusted federal taxable estate for resident decedents should be computed as follows:

$$\text{Adjusted federal taxable estate} = \text{Federal taxable estate}^{285} + \text{Gifts made within 3 years}^{286}$$

The estate would reduce the above amount by the available Oklahoma exemption²⁸⁷ and then apply the Oklahoma rate table to calculate the estate

Oklahoma gross estate		\$1,000,000	
Marital deductions	\$600,000		
Exemption	<u>(175,000)</u>		
Allowable reductions		<u>775,000</u>	
Taxable estate			\$325,000
Tax on above amount			\$ 11,225
Portion allocated to Oklahoma (60%)			\$ 6,735

Similarly, the decedent is undertaxed in Oklahoma if the Texas real estate passes to the surviving spouse and the Oklahoma property passes to the child.

282. The same problem exists with respect to other deductions. A mortgage against the Texas real estate reduces the Oklahoma tax liability since a portion is deductible for Oklahoma purposes. It is more difficult to allocate direct and indirect deductions against out-of-state property. In addition, there is less need since the focus still remains on the total wealth which the decedent is transmitting, and the amount of Oklahoma tax should not necessarily be affected if a resident elects to secure a debt against out-of-state property rather than Oklahoma property.

283. Compare I.R.C. § 2056(b)(2) (1994) (disallowing a marital deduction to the extent that the transfer to the surviving spouse can be satisfied with assets for which no deduction would be allowed, regardless of whether those assets are actually transferred to the spouse).

284. Of course, this does not prevent the survivor from evading Oklahoma estate tax by changing residency after the first spouse's death. *See supra* notes 259-60 and accompanying text.

285. I.R.C. § 2051 (1994); Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 1993), at 1, line 3 [hereinafter Form 706]. In the event that a federal return is not filed, the amount would be computed as if a federal return were required.

286. This amount includes all gifts made within three years of death (including gifts of real property and tangible personal property located outside Oklahoma) other than: (1) gifts already included in the federal gross estate and listed on line 1, Form 706; (2) gifts which qualify for the gift tax annual exclusion as set forth in I.R.C. § 2503(b); and (3) transfers for educational or medical purposes as set forth in I.R.C. § 2503(e). *See supra* notes 247-52 and accompanying text.

The legislature should also consider including in the survivor's gross estate the value of QTIP property disposed of during the survivor's life. *See supra* note 27.

287. The legislature should abandon the ill-conceived exemption for qualifying farms and businesses and should consider the desirability of having a single exemption for all beneficiaries. The legislature may elect to either increase or decrease the current exemption. *See supra* notes 61-88 and accompanying text.

tax.²⁸⁸ This formula imposes an Oklahoma tax on all gifts made within three years of death, regardless of motive.²⁸⁹

If the adjusted federal taxable estate includes real property or tangible personal property located outside Oklahoma,²⁹⁰ the tax computed above would have to be apportioned. That portion allocated to Oklahoma would be computed as follows:

$$\begin{array}{rcl} \text{Tax apportioned} & & \text{Property subject} \\ \text{to Oklahoma} & = & \text{to tax in} \\ \text{property} & & \text{Oklahoma}^{291} \\ & & \text{Adjusted federal taxable estate} \\ & & \text{computed above} \\ & & \text{Oklahoma property} \\ & & \text{— qualifying for marital} \\ & & \text{or charitable deduction}^{292} \end{array}$$

Similar issues arise with respect to nonresidents. Under current law, a nonresident decedent must include in the Oklahoma tax base only real property and tangible personal property located in Oklahoma.²⁹³ The estate then reduces that amount by a proportionate amount of the deductions (including the marital deduction) and the exemption to which the estate would otherwise be entitled.²⁹⁴

A more equitable approach is to compute the adjusted federal taxable estate as if the decedent were an Oklahoma resident, taking into account all gifts made within three years of death,²⁹⁵ reduce that amount by the full exemption to which a resident would be entitled, and then apply the Oklahoma rate table. The tax apportioned to Oklahoma would be computed as follows:

288. The current exemption of \$175,000 is limited to transfers to the decedent's parents and descendants. 68 OKLA. STAT. § 809(A) (Supp. 1996). If the legislature retains this limitation, the tax on transfers to the decedent's parents and descendants must be computed separately from the tax on other transfers. The legislature may elect to increase or decrease the current \$175,000 exemption.

289. See *supra* notes 131-41 and accompanying text.

290. This includes gifts comprised of out-of-state real property or tangible personal property made within three years of death.

291. The property subject to tax in Oklahoma includes all property included in the adjusted federal taxable estate computed above other than: (1) out-of-state real property and tangible personal property included in the federal gross estate; and (2) gifts of out-of-state real property and tangible personal property made within three years of death.

292. This amount includes all property subject to tax in Oklahoma: (1) which passes (or has passed) to the surviving spouse and which qualifies for the federal estate tax (or gift tax) marital deduction; or (2) which passes (or has passed) to charity and which qualifies for the federal estate tax (or gift tax) charitable deduction. An Oklahoma marital and charitable deduction would be disallowed to the extent that a bequest can be satisfied with out-of-state real property or tangible personal property, regardless of whether that property is actually transferred to the surviving spouse.

293. 68 OKLA. STAT. § 807(A)(1) (1991). In certain situations, intangible personal property owned by nonresidents is taxed in Oklahoma. See 68 OKLA. STAT. § 807(A)(1), (7); *Perkins v. Oklahoma Tax Comm'n*, 428 P.2d 328, 330-31 (Okla. 1967).

294. 68 OKLA. STAT. § 809(A) (Supp. 1996). In other words, if a nonresident decedent owned real estate in Oklahoma which passes to the surviving spouse, the estate will only be entitled to claim a marital deduction for a portion of the value of that property based on the value of Oklahoma property as compared to the value of all property which the decedent owned.

295. See *supra* notes 285-92 and accompanying text.

$$\begin{array}{rcccl} \text{Tax apportioned} & & \text{Real and tangible} & \text{Oklahoma property} \\ \text{to Oklahoma} & = & \text{personal property} & \text{--- qualifying for marital} \\ \text{property} & & \text{in Oklahoma} & \text{or charitable deduction} \\ & & \text{Adjusted federal taxable estate} & \\ & & \text{computed above} & \end{array}$$

Note that this is the same approach used for residents, with the only difference being the property included in the numerator. The formula therefore incorporates into the calculation of the Oklahoma estate tax for nonresidents those same adjustments delineated above for residents. It also avoids taxing nonresidents at the lower Oklahoma marginal rates.²⁹⁶

Conclusion

A significant period of time has passed since there have been major changes to the Oklahoma estate tax. The amendments passed in 1996 only create additional need to revisit the Oklahoma estate tax. The legislature should commission a study to determine the true economic effect of a pickup tax rather than relying exclusively on the estate tax revenue loss projections prepared by the Oklahoma Tax Commission. At a minimum, the legislature should conform the Oklahoma and federal estate tax laws.

296. Under existing law, nonresidents are only required to include in the Oklahoma tax base real and tangible personal property located in Oklahoma. Even though the exemption available to the estate is reduced to reflect that portion of the total estate taxable in Oklahoma, the estate still enjoys the benefit of having the entire Oklahoma estate taxed at the lower marginal rates. For example, if a decedent had a \$1,000,000 estate and if the decedent gave Oklahoma real estate valued at \$100,000 to a child, the estate will receive only a \$17,500 exemption which is \$175,000 times a fraction, the numerator of which is \$100,000 and the denominator of which is \$1,000,000. The total Oklahoma estate tax would be \$1412. 68 OKLA. STAT. § 803(1) (1991). Under the approach advocated above, the Oklahoma tax would be \$4572, which is the tax on \$825,000 (\$1,000,000 less the full \$175,000 exemption), multiplied by 10%.