newsletter

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Let's Finish The Job We Started In 1995: Why We Should Adopt The Revised Uniform Principal And Income Act

From time immemorial, estate planners have drafted trusts that, when they become irrevocable, require the trustee to manage investments and distributions to satisfy conflicting interests: the current beneficiary's need for adequate income and the future beneficiaries' expectation of capital growth. In attempting to reconcile these conflicting objectives, the trustee must invest some of the trust portfolio for growth and some for income. For all practical purposes, the trustee must manage two portfolios that require constant rebalancing over time to maintain some roughly appropriate division between growth and income objectives.

The advent of modern portfolio theory brought the opportunity to consider alternative solutions that reduce the conflict between current and future trust beneficiaries. Many well-documented studies provide strong evidence that investing for total return, with consideration for the effects of economic conditions, taxation, and inflation, is more efficient in controlling investment risk, providing for a defined level of income, and producing long-term growth.[1] The total-return trustee does not construct an investment portfolio to fit arbitrary allocations between income and principal. Instead, the total-return trustee might, after due analysis, conclude that a portfolio composed entirely of stocks would best fit the needs of the trust beneficiaries. Unlike the traditional trustee, who regarded principal in terms of preservation and income as something to be produced and spent, the trustee who manages for total return draws no distinction between income and principal in building the portfolio.

The adoption of the Uniform Prudent Investor Act in 1995 made clear that total-return investing is authorized in Oregon: "A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of the overall investment strategy having risk and return objectives reasonably suited to the trust." ORS 128.196(2). The Uniform Prudent Investor Act also requires the trustee to consider general economic conditions, the effects of inflation and deflation, the tax consequences of investment actions, and the relationship between investments and the other kinds of assets held by the

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trust, as well as the particular circumstances of the trust and its beneficiaries. ORS 128.196(3).

Current Oregon law does not, however, deal well with some crucial corollaries of total-return investing. If a trustee reaches a reasoned conclusion that an all-stock portfolio would best serve a particular trust, little or no income is likely to be produced for the current income beneficiary. Properly supporting that beneficiary would then, as a practical matter, necessitate discretionary principal distributions, assuming the trust permits distributions. Such a zigzag process may defeat the purpose of total-return investing and requires excessive administrative effort by the trustee.

In 1997, the National Conference of Commissioners on Uniform State Laws, recognizing a need to facilitate trust investing under modern portfolio theory and to modernize the law concerning trust principal and income, revised the Uniform Principal and Income Act (the "Act").

Highlights of the Act

Discretionary Power of Administration and Power To Adjust. Unless prohibited by the governing instrument, the trustee may exercise a discretionary power of administration to adjust between principal and income to the extent the trustee considers necessary, if (1) the trustee invests and manages trust assets as a prudent investor, (2) the terms of the trust refer to the trust's income in describing the amount that may or must be distributed to a beneficiary, and (3) the trustee determines that using traditional standards for determining net income will result in a violation of the trustee's duty of impartiality by unduly favoring or damaging the interests of current or future beneficiaries. Uniform Principal and Income Act of 1997 ("UPAIA") §§ 104(a), 103(b). "Adjusting" between principal and income means that the trustee may determine what a reasonable net income distribution should be and distribute it, taking it first from trust income as traditionally determined and then from principal if needed.

An exercise of the power to adjust between principal and income must be made with due regard for the trustee's duty of impartiality toward all beneficiaries. Should investment methodology result in no net income or inadequate net income, measured with reference to traditional standards, fulfillment of the duty of impartiality will require that the trustee consider exercising discretion to allocate funds—perhaps four percent of the market value of total trust assets each year—to provide a reasonable income to the current income beneficiary. The result must be "'fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more beneficiaries."' *Id*. § 104 cmt ¶ 4 (quoting UPAIA § 103(b)).

The power to adjust cannot be exercised in a vacuum. The Act requires due consideration of "all factors relevant to the trust and its beneficiaries," including, when relevant, the nature, purpose, and duration of the trust; the trustor's intent; the identities and circumstances of the beneficiaries; the trust's needs for liquidity, regularity of income, and preservation and appreciation of capital; the nature of the trust's assets; the net income determined under various sections of the Act (for example, income from discount bonds or natural resources); trust provisions for principal invasion and prior practices regarding invasions; the effects of economic conditions, including inflation and deflation; and the tax consequences of an adjustment. *Id*. § 104(b).

The power to adjust is not available when its exercise would disqualify a marital deduction or cause other changes in intended tax consequences. *Id*. § 104(c). Adjustment power is also unavailable when the trustee is a beneficiary of the trust or would benefit directly or indirectly from the adjustment. *Id*. The trustee can make a

Get Involved in Law Reform: Volunteers Needed

The Section is seeking volunteers for a number of continuing and new legislative projects.

An update on the legislative work done by the Section during the past year, together with information about future projects, will appear in the July issue.

Committee work on the new projects will begin in the fall.

Contact Susan N. Gary, the Newsletter editor, to volunteer.

full or partial "release" of the power of adjustment to avoid undesirable tax consequences. *Id*. § 104(e). Provisions in the governing instrument do not eliminate the power of adjustment unless it is clear that the limitations were specifically intended to prevent the trustee from having this power. *Id*. § 104(f).

If a claim is made that the trustee abused discretion by exercising or refraining from exercising the power to adjust, the primary remedy available to the court is to reverse the adjustment after finding abuse of discretion. If the trust cannot be made whole in this way, the court may impose personal liability on the fiduciary. *Id*. § 105 (adopted by NCCUSL in 2001).

Determining and Distributing Net Income. Net income is determined with reference to the Act's rules for various types of assets. The Act retains differential treatment of beneficiaries receiving pecuniary bequests from estates and those receiving such bequests from trusts: Income earned before the testator's death is principal, but income earned before the trustor's death is income for the successive income beneficiary. *Id.* § 201(3)-(4); ORS 129.055. The Act changes the allocation of uncollected income between a terminating trust income interest and the successive trust income interest to provide that the uncollected income passes to the successive income interest. *Id.* § 303(a). The trustee will be required to accumulate trust income during any period when there is no current trust income beneficiary. *Id.* § 301(c), -(d); see also *Id.* § 301 cmt.

All corporate distributions other than cash are allocated to principal. As an example, dividends that are immediately reinvested in shares of stock will become principal. *Id.* § 401(c). This rule may indicate use of the power to adjust in many cases.

Updated Rules for Distributions by Types of Entities or Activities. When the 1962 Principal and Income Act was promulgated, many of the investment securities available today had not yet been created. The revised Act provides for the allocation of receipts from traditional entities such as partnerships and corporations, as well as limited-liability companies, real estate investment trusts, and other pass-through vehicles such as mortgage-backed securities. *Id.* § 401. Trustees may account separately for businesses, farms, livestock operations, portfolios of derivatives, mineral extraction operations, and timber operations. *Id.* §§ 403, 414(b). Required distributions from deferred-compensation arrangements, annuities, and similar assets are allocated to principal and income, if determinable; otherwise, 10 percent of required distributions is allocated to income, while 100 percent of distributions not required to be made is allocated to principal. *Id.* § 409. Ten percent of distributions on natural resources and on liquidating assets, such as oil wells, is allocated to income. *Id.* §§ 410, 411. Distributions for harvested timber are allocated pursuant to the accounting practices used for the timber operations before trust ownership. Alternatively, allocations must be made to principal to the extent that the amount of timber removed from the land exceeds the growth rate of the block of timber as a whole during the applicable accounting periods. *Id.* § 412.

Distributions from Income. Expenses that must be paid from income include one-half of trustee and investment advisor fees and one-half of expenses for accountings, judicial proceedings, and other matters involving both the income and remainder interests. All other ordinary expenses for the administration, management, or preservation of trust property, including interest, ordinary repairs, casualty insurance premiums, and property taxes, are paid from income. *Id.* § 501. The fiduciary has discretion to pay, from either principal or income, expenses of an estate or terminating income interest in a trust, such as attorney and accountant fees, court costs, interest on death taxes, and other administrative expenses. All other expenses of an estate or terminating income interest in a trust, such as funeral expenses, family allowances, and death taxes and related penalties, are to be paid from principal. *Id.* § 201(2).

Distributions from Principal. Expenses to be paid from principal include the other half of trustee and investment advisor fees, accounting expenses, and expenses of judicial proceedings. Other expenses to be paid from principal include trustee fees calculated on principal as acceptance, distribution, or termination fees; disbursements to prepare property for sale; insurance premiums other than casualty insurance, so long as the trust owns and is beneficiary of the policy; transfer and death taxes, including penalties; and environmental-remediation expenses. *Id.* § 502.

Adjustments due to Taxes. The power to adjust may be used to make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries due to tax elections and decisions the fiduciary makes, or due to any income or other tax imposed on the fiduciary or a beneficiary as a result of a transaction involving a trust or estate distribution. *Id.* § 506(a)(1)-(2). This power to adjust also extends to a situation in which the trust or estate owns an interest in an entity whose taxable income, whether or not distributed, is includible in the taxable income of the estate, the trust, or a beneficiary. *Id.* § 506(a)(3).

The fiduciary must reimburse the principal of a trust or estate from income when a marital or charitable deduction is reduced because of the fiduciary's election to take deductions on an income tax return instead of the estate tax return. The adjustment is limited to the amount of the increase in the estate tax, to the extent that the principal used to pay the increase would have qualified for a marital or charitable deduction. *Id.* § 506(b); *see also Britenstool v. Commissioner*, 46 TC 711 (1966).

What Other States Have Done

Twenty-five states, including populous ones such as New York, California, and Connecticut, have adopted the Act.[2] Most of these states adopted the Act substantially as drafted.

Several states have enacted legislation authorizing the conversion of trusts with traditional income provisions to private unitrusts, while also adopting the power to adjust between principal and income. New York enacted legislation that allows both existing and future trusts to elect to be either a unitrust or a traditional trust with the power to adjust. New York Estates, Powers and Trusts Law §§ 11-2.3, 11-2.4. This state act provides that the unitrust rate for the first three years is four percent of the market value of trust assets, measured as of the first business day of the year. After the first three years, the unitrust rate is four percent of the rolling average trust market value of the preceding three years, to smooth out fluctuations in asset values.

Tax Issues

Concerns about the income tax consequences of making allocations in a total-return trust delayed early adoption of the Act in many states. In February 2001, the IRS issued Prop Treas Reg § 1.643(b)-1. This proposed regulation provides that allocations between income and principal under state law will be respected if the law provides for a "reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year," taking into account ordinary income and capital gains. If state law permits the income beneficiary to receive an annual unitrust amount that is between three percent and five percent of the annual fair market value of the trust assets, such distributions will comply with the definition of trust income. The same is true for allocations to income under the power to adjust, referred to in the proposed regulation as "equitable adjustments" fulfilling the trustee's duty of impartiality. In addition, the power to adjust and the unitrust will not disqualify the marital deduction.

In a total-return trust, it is possible that "income" determined under the power to adjust will include capital gains, which are normally not part of net distributable income. However, capital gains allocated to income under the governing instrument or state law in a total-return trust may be included in distributable net income. The proposed regulation recognizes this possibility and provides that a state law "ordering rule," analogous to the ordering rules for charitable remainder trusts, will be respected. Such a rule would provide that the unitrust distribution be paid first from ordinary income, then from net short-term capital gain, then from long-term capital gain, and last from return of principal. Prop Treas Reg 1.643(a)-3(e), ex 9.

Finally, the proposed regulation makes it clear that converting a grandfathered generation-skipping trust to a unitrust, or using the power to adjust in such a trust, will not cause loss of the grandfathering.

Recommendation

It is time to enact the new Uniform Principal and Income Act, including a provision allowing existing trusts to be converted to unitrusts. There is no longer any reason to deny trustors and trustees the option to use these modern administrative tools.

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Endnotes

1. *See* Jonathan R. Macey, *An Introduction to Modern Financial Theory* 17-18, 28 (2d ed 1998).
2. The states that have enacted the Act as of late 2001 are Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Hawaii, Idaho, Iowa, Kansas, Maryland, Minnesota, Missouri, Nebraska, New Jersey, New Mexico, New York, North Dakota, Oklahoma, South Carolina, Tennessee, Virginia, West Virginia, Wyoming; the District of Columbia has also enacted it.

UTCR Probate Court Accountings

Amendments to Chapter 9 of the Uniform Trial Court Rules ("UTCR") effective August 1, 2001, and amendments (including a standardized form) have significantly changed estate and conservatorship accountings. The new rules and form are mandatory in Multnomah County, will probably become mandatory in other larger counties, and will facilitate auditing everywhere. All judicial districts must accept the new format, UTCR 9.160, but counties can decide independently whether to make the format mandatory. UTCR 9.160(4). The rules and a sample form can be found at the Oregon Judicial Department web site, www.ojd.state.or.us/ojdinternet.nsf/ByDominoFilename/UTCR2001.pdf/$FILE/UTCR2001.pdf. This article discusses a number of specific accounting issues.

Term of Accounting

The accounting narrative must include the first and last day of the accounting period. For annual accountings, the last day of the accounting period must be within 30 days of the anniversary of appointment of the fiduciary. UTCR 9.160(1)(a). This 30-day "window" allows the personal representative or conservator flexibility in picking the accounting date for the sake of expediency. For example, either the last day of the month or the date at which the bank statement summarizes account activity can be used.

Bond

A formula must be used for determining the amount of the current bond, if any. UTCR 9.160(1)(b). This formula is supposed to force practitioners into calculating the statutory bond amount and to alert the court auditor as to whether the bond is sufficient. The formula can be adjusted to reflect other item, such as anticipated legal and fiduciary fees. The critical issue is to maintain a logical formula. If no bond is required, the accounting must include a statement that the fiduciary is not required to post a bond pursuant to ORS 125.410(2)(a) or that the bond has been waived by the court and the date of such waiver order. UTCR 9.160(1)(b).

If the estate includes restricted assets, the inventory or accounting must include a notation of the restricted assets, with reference to the date and title of the order imposing the restriction. UTCR 9.050. Confirmation by the depository of its receipt of the restricted asset must be filed with the court within 30 days of the restriction order, unless the court allows a longer period of time. *Id.*

Asset Schedule

The accounting must include a separate asset schedule of all property of the estate or conservatorship owned at any time during the accounting period. UTCR 9.160(2). This asset schedule should be a "summary," not an accounting with receipts and disbursements, as some practitioners are reading the rule. The schedule must have at least five columns. UTCR 9.160(2)(a). These columns are as follows:

All Assets. The first column lists all assets in existence at any point during the accounting period. It also has other requirements: notation of restriction, date of disposition or disposal, and reference to the exhibit containing receipts and disbursements. These additional requirements are placed in the first column because they would sabotage some accounting computer programs if placed in another (perhaps more relevant) column.

Value at the Beginning of Accounting. The asset schedule should begin with the assets listed in the inventory or the last accounting, and their value in the inventory or at the end of the last accounting period will be the value in the second column. Often, during an accounting, it is discovered that the inventory value for an asset is incorrect. This can be corrected here with an explanation. If the error is significant, perhaps it should also be explained in the narrative of the accounting.

Value of Later-Acquired Asset. If the asset was discovered, found, purchased, or otherwise acquired after the beginning of the accounting period, the third column states the value at and the date of acquisition. The distinction between a second-column beginning asset and a third-column later asset has been a source of confusion. The drafters' intent was that the later asset would be one with a new "label" and would not represent the increase in value of or addition to an existing asset. A simple way of interpreting the distinction is that if the asset would ordinarily be listed in an inventory, it is a later-acquired asset. The critical issue, however, is that it appear in the asset schedule, not the specific column in which it appears.

An example of a later-acquired asset is a land sale contract that is sold or pays out, but only if the proceeds are invested in a new bank or brokerage account. If the proceeds are deposited in an existing bank or brokerage account, the account would not be a later-acquired asset.

A gray area involves the establishment of estate or conservatorship accounts from a decedent or protected person's preexisting accounts. Perhaps the best approach is to make the decedent or protected person's preexisting account a column-two asset but make the transfer to a new account after appointment of the fiduciary a column-three asset.

Value at Disposition. If the asset was sold, redeemed, gifted, lost, abandoned, or otherwise disposed of before the end of the accounting period, the fourth column states the value and date of disposition. For example, a $100 car given to a nephew is a fourth-column asset. The value shown in the fourth column would be $100 because that was the value at disposition. If $100 cash was given from a checking account that continues to exist, that is not a fourth-column asset, because the account, not the $100 check, is the asset.

Household furniture sold at an estate sale is another example of a fourth-column asset, with the sale proceeds appearing in the fourth column. The sale proceeds, if deposited in an existing account, would appear as a receipt in the list of receipts and disbursements, rather than in this schedule. If the sale proceeds were used to open a new account, the new account would appear in column three.

Current Value. If the asset is in existence on the last day of the accounting period, the fifth column states the current value. This column, in turn, will become the second column in the next accounting's asset schedule or will indicate what is available to meet the estate distribution.

In General. The sum of each column must appear at the bottom. UTCR 9.160(2)(b). The sum of the second column is the sum showing in the inventory or last accounting (unless adjusted by some reporting error). The sum of the fifth column is the total current asset value. These two figures should be helpful in the preparation and auditing of the account. The sums of the third and fourth columns are generally not particularly helpful and do not correlate with the second or fifth columns.

The schedule can also include additional information that would aid in accounting for assets. UTCR 9.160(2)(c). However, only a small amount of information should be included, because this schedule is a "summary." UTCR 9.160(2). The value of household goods and personal belongings can be totaled on one line. UTCR 9.160(2)(d).

Receipts and Disbursements

The statutory requirement of an accounting of receipts and disbursements is detailed in UTCR 9.160(3). A chronological statement must show the date and value of each transaction. The total of each list of receipts or disbursements must be provided at the end of each list. Each account must be accounted for separately. UTCR 9.160(3)(a).

The preparation and auditing of an accounting is simplest when each account is handled separately. The national trend, and the practice of a small number of Oregon practitioners, is to blend receipts and disbursements of all accounts into one list. This approach was specifically rejected by the UTCR Committee.

Receipts should show the source and include a brief explanation of the source or purpose of the entry. The first entry in the list of receipts is the beginning balance for the account. UTCR 9.160(3)(b).

Disbursements should show the payee or recipient and include a brief explanation of each disbursement's purpose. If the disbursement is by check, the payee's name on the check must match the name on the disbursement. UTCR 9.160(3)(c).

Transfers within accounts or to other accounts have been a source of confusion in the preparation and auditing of accountings. These transfers have also been used to hide misappropriation. Now, inter- and intra-account transfers must indicate the source or destination of the deposit or withdrawal. UTCR 9.160(3)(e).

The statutory requirement to show receipts and disbursements has always created much difficult work in the accounting of complicated brokerage and mutual fund accounts. Practitioners regularly ignore the requirement and provide only beginning and final values. This new rule for transfers suggests even more work. The author, after consultation with court staff, believes that practitioners should take a practical approach to these strict requirements. In some situations the court may require only an accounting of funds entering or leaving the brokerage or mutual-fund account, rather than an accounting of all internal activity within the account.

Differences between the account balance and the depository statement balance must be reconciled. UTCR 9.160(3)(f). The form also calls for an internal reconciliation of the account's receipts and disbursements. Not surprisingly, conversations with court staff affirm that these criteria are being ignored.

Vouchers required by court or rule must accompany the accounting as a separate exhibit or attached to a cover page showing the case caption. UTCR 9.180(1). Courts do not want vouchers welded directly to the account narrative, as this makes it difficult to return vouchers on request.

Unless excused by court or rule, or provided in the previous accounting, opening and closing depository statements must be provided. UTCR 9.180(2). Further, in a sale of real property, a copy of the seller's closing statement or a similar document must be provided. UTCR 9.160(3)(d).

Narrative

The narrative must describe any changes in the assets of the estate or the financial life of the protected person. Examples given in the rule include a stock split and a significant change in living expenses. UTCR 9.160(4). Other examples include closing a checking account after the checkbook was stolen and depositing in a bank account the substantial proceeds of a sale of real property.

Fiduciary Disclosure

The narrative of the accounting must specifically disclose and explain gifts, transactions with a person or entity with whom there might be a conflict of interest, and payments to a person who does not ordinarily engage in business or payments in an amount higher than that ordinarily charged to the public. UTCR 9.170. Practitioners should review the text of this rule very carefully and provide a copy to clients to place them on notice of the reporting requirement.

Paragraph or Exhibit

The rules allow both the asset schedule and the list of receipts and disbursements to be included as separate paragraphs in the narrative or as exhibits attached to the accounting.

Conclusion

Regardless of whether the accounting format is made mandatory in a county, use of the form will certainly make auditing easier and facilitate the processing of clients' orders.

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Use Caution in Taking Advantage of the New Law Allowing Custodial Accounts to Last Until Age 25

The 2001 Oregon legislature changed the Oregon Uniform Transfers to Minors Act (the "Oregon UTMA"), ORS 126.805-.886, to allow custodial accounts established for minors to last until age 25. The change may be helpful for many clients, but presents a tax trap if the custodial account is used for lifetime gifts.

Many clients make gifts to their minor children or grandchildren using custodial accounts as a simple way to give valuable assets to a minor. The custodianship, of course, is a statutory trust but is easier and less expensive to set up than a custom trust.

Generally speaking, gifts in trust are considered gifts of future interests and therefore are ineligible for the annual exclusion from gift tax. IRC § 2503(b). Gifts to a traditional custodianship are treated as gifts of present interests by IRC § 2503(c) and consequently are eligible for the annual exclusion from gift tax. Rev Rul 56-86, 1956-1 CB 449.

As a result of the 2001 legislation, donors to custodial accounts can now elect to have the account last until the beneficiary attains age 25. ORS 126.872. This may allow practitioners to simplify estate plans when a trust for a child or grandchild lasting until age 25 would otherwise be needed. However, caution is required when using the new provision in connection with lifetime gifts.

Because present interest treatment under IRC § 2503(c) is limited to gifts to trusts that terminate when the beneficiary attains age 21, a gift to a custodial account lasting until age 25 will not qualify for annual exclusion treatment. Therefore, most clients making lifetime gifts should not take advantage of the ability to extend the custodianship to age 25. Fortunately, a more attractive alternative may exist for some clients, in the form of gifts to the Oregon College Savings Plan or similar plans offered by other states under IRC § 529. Such gifts qualify for the annual exclusion under IRC § 529(c)(2)(A) and give extraordinary powers to the account owner, including the power to withdraw the contribution at a later date, change the account beneficiary, and control the timing of distributions. ORS 348.841-.873; IRC § 529(c). However, contributions to such plans must be in cash, and the account owner has only limited control over investment decisions. IRC § 529(b).

Therefore, clients who wish to make lifetime gifts of appreciated securities or other property, or who want to give the custodian complete investment control, may prefer the Oregon UTMA. If annual exclusion treatment is important with respect to such gifts, the custodial account should be set up to terminate at age 21.

Another issue sometimes overlooked in using custodial accounts is that if the custodian is the donor to the account and dies before the custodial property is transferred to the account beneficiary, the property in the account will be included in the donor's estate. IRC § 2038; Rev Rul 70-348, 1970-2 CB 193; Rev Rul 57-366, 1957-2 CB 618. Because of this problem, it is best if the account donor is not the custodian, particularly if a grandparent with a potentially taxable estate is making gifts to a grandchild.

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Oregon Estate Tax Warning
ORS 118.010

How many married couples residing in Oregon have been advised that no state or federal estate taxes will be due when the first spouse dies? For married decedents dying after January 1, 2002, that advice may no longer be accurate. How many unmarried individuals residing in Oregon with estates valued at just over $1 million would benefit by implementing simpler discounting and transfer strategies to avoid Oregon estate taxes? This article provides a brief look at the impact on the Oregon estate tax laws created by the recent federal estate tax changes and suggests ways to help clients respond to the current uncertainties resulting from the mismatch between federal and state law.

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes in the federal estate tax law, including changes to the state death tax credit. EGTRRA gradually reduces and ultimately repeals that credit. *See* IRC § 2011. Various provisions of the Oregon estate tax law are linked to federal estate tax provisions. First, ORS 118.160 provides that no Oregon estate tax return will be required to be filed and no Oregon estate tax will be due unless a federal estate tax return is required to be filed. Second, the amount of the Oregon estate tax is determined by ORS 118.010(2), which is specifically linked to IRC § 2011. On June 6, 2001, the Oregon Legislative Committee issued an opinion letter concluding that Oregon's estate tax rate was based on IRC § 2011 as it existed on April 28, 1997, when the legislature last amended ORS 118.010(2). Indeed, the Oregon Constitution prohibits the legislature from delegating legislative decision-making to Congress by tying a provision of the Oregon statutes to future changes in a federal law.[1]

On January 14, 2002, the Oregon Department of Revenue (the "ODR") released a "Policy Statement Regarding Administration of the Oregon Estate Tax,"[2] announcing that any estate valued at under $1 million will not be required to file an Oregon estate tax return. In the process of analyzing this issue, the ODR discovered that it had been applying the Oregon estate tax based on the federal estate tax exclusion amounts enacted in the Taxpayer Relief Act of 1997, which was adopted on August 5, 1997, rather than the federal exclusions that existed on April 28, 1997.

Since January 1, 1998, the ODR has administered the Oregon estate tax laws using the federal exclusion amount of $700,000, the current amount provided for under the Taxpayer Relief Act of 1997, rather than $600,000, the exclusion amount in effect on April 28, 1997. Although technically the Oregon estate tax exemption should be $600,000, the ODR will continue to administer the Oregon estate tax as if the $700,000 exemption applies, and has asked the legislature to clarify its intent during the upcoming special budget session or the 2003 legislative session.[3] Oregon lawyers and their clients now face significant drafting, administration, and taxation issues involving the Oregon estate tax, including the following:

- For purposes of determining whether an Oregon estate tax return must be filed, the ODR will apply the federal estate tax law as amended by EGTRRA.
- For purposes of determining the Oregon exclusion amount, the ODR will apply the federal estate tax law *as amended by the Taxpayer Relief Act of 1997 and will not follow the reductions made by EGTRRA.*
- An Oregon estate tax liability may exist for estates in excess of $700,000 (or possibly $600,000) even though no federal estate tax is due.
- Credit-shelter trusts created as a result of deaths in 2002 and 2003 may have been drafted using a funding formula that unexpectedly causes an Oregon estate tax to be due.

As of January 1, 2002, estates of decedents dying in 2002 or 2003 that are valued at less than $1 million will not be required to file a state or federal estate tax return, and no Oregon estate tax will be due. However, unless changed by the legislature in 2003, estates of decedents dying in 2002 or 2003 that are valued at more than $1 million will require an Oregon estate tax return, and the Oregon estate tax will be based on the net value of the estate *in excess of $700,000* after taking into account the federal estate tax credits other than the state death tax credit. Under this interpretation, an estate valued at $999,999 would owe no Oregon estate tax, because a federal estate tax return is not required to be filed. However, an estate valued at $1,000,010 would owe an Oregon estate tax of $33,201, and the estate would be entitled to only a $4 state death tax credit on the federal estate tax return.

In addition, married couples whose estate plans include credit-shelter trusts may face unexpected Oregon estate taxes. For example, if (1) the first spouse dies in 2002 or 2003, (2) the credit-shelter trust is funded based on a federal exclusion-amount formula (currently $1 million), as opposed to the Oregon exemption amount of $700,000 (or possibly $600,000), and (3) a federal estate tax return is *required* to be filed, an Oregon estate tax of $33,200 would be due even though no federal estate tax is due. This tax will come as a rude and untimely shock to most surviving spouses—not to mention their estate planning advisors.

Disclosures to Clients. With the pending uncertainty of the tax exclusion amount and filing requirements, practitioners should advise their clients that there may be variations in the Oregon estate tax consequences. In addition, married clients with estates valued in excess of $700,000 (or even $600,000) should be advised of the computational change. The married clients can then decide whether they want to (1) amend the funding formula for the credit-shelter trust and link it to the Oregon exemption amount (currently $700,000, but possibly $600,000) or (2) leave the funding formula at the federal exclusion amount (currently $1 million) and be prepared for the possibility of paying an Oregon estate tax after the first spouse dies.

Drafting Tips. The present uncertainty about the Oregon exemption amount affects the credit-shelter trusts for married couples and the formula language used to draft them. In response to those concerns, several approaches can be considered.

One approach is to amend the funding formula for the credit-shelter trust to reduce it to the amount that is exempt from state death taxes (currently $700,000, subject to the $600,000 caveat). A trust with this type of formula should have a backup disclaimer provision so that the surviving spouse may elect to fund the credit-shelter trust to utilize all, or substantially all, of the federal exclusion amount and pay the Oregon estate tax if a federal estate tax return is required to be filed. Thus, if a federal estate tax return is required, the surviving spouse would have the choice to pay no state or federal tax or to pay the Oregon estate tax and get the full benefit of the federal exclusion. If a federal estate tax return is not required, the surviving spouse could use the disclaimer backup to restore up to $300,000 to the credit-shelter trust, and (probably) no Oregon estate tax would be due.

A second approach is to continue funding the credit-shelter trust with the full federal exclusion amount but to authorize the personal representative or trustee, if a federal estate tax return is required, to have the power to make a QTIP election for the portion in the credit-shelter trust in excess of the Oregon exemption amount. If the fiduciary makes a QTIP election, then no Oregon estate tax would be due, but the surviving spouse's estate would be enlarged by the amount of the QTIP election, currently the $300,000 difference between the federal exclusion of $1 million and the Oregon exemption of $700,000.

A third approach is to use a general disclaimer will or disclaimer trust. Such a document would leave the entire estate to the surviving spouse but would also direct that any assets disclaimed by the surviving spouse pass into a credit-shelter trust. This simple approach allows the surviving spouse to have the choice of funding the credit-shelter trust based on either the Oregon exemption amount or the federal exclusion amount. However, the apparent simplicity of this approach can be misleading. To implement this approach properly, the surviving spouse must act very quickly to execute a written disclaimer after the death of the first spouse. Subject to certain exceptions, the surviving spouse *must execute the disclaimer before he or she begins to use the estate assets for his or her own benefit* and within nine months of the date of the deceased spouse's death. If any requirement is not met, the disclaimer will fail as a qualified disclaimer under federal estate tax law.

None of these choices are particularly satisfying. If the surviving spouse chooses the Oregon exemption and pays no taxes now, his or her heirs are likely to face a significantly larger federal estate tax when the surviving spouse dies. Alternatively, after the first spouse dies, the surviving spouse can pay the Oregon estate tax with the substantial likelihood of paying less federal estate tax. For couples who do nothing, the surviving spouse will likely be surprised to learn that an Oregon estate tax is due when he or she expected to pay nothing.

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

Administration Tips. When distributing Oregon estates valued at between $600,000 and $1 million for decedents dying in 2002 or 2003, practitioners may want to consider these options: (1) leave the estate open with enough cash to pay the Oregon estate taxes if they are required; (2) file the estate tax return, pay the taxes, and request a refund later, if appropriate; or (3) advise the personal representatives to

Questions, Comments or Suggestions About This Newsletter?

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have the beneficiaries sign a refund agreement that includes an acknowledgment of the inheritance and an agreement to pay the taxes if they are later due.

The Future. The ODR is currently drafting a proposed estate tax return to accommodate the reporting of these computational changes and is seeking input from the professional estate planning community. Anyone interested in reviewing and commenting on the provisions of the Oregon estate tax return should contact Linda Stone at the ODR (503-945-8658).

The ODR will ask the Oregon legislature at the 2003 session to determine whether a separate state estate tax structure should be adopted for the future and clarify whether it intended all of ORS chapter 118 to be tied to the Taxpayer Relief Act of 1997. In the meantime, estate planners will have to wait to see how the Oregon legislature responds. And practitioners should keep their pre-2001 estate tax calculation software. It will be helpful in calculating the computational changes in the Oregon estate tax that are effective January 1, 2002. If the legislative intent is not clarified during the 2003 legislative session, it may be necessary to reinstall pre-Taxpayer Relief Act of 1997 software to compute the further revised Oregon estate tax.

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Endnotes

1. For a detailed discussion of the constitutional law and the statutory construction case law interpreting the constitutional issues, visit www.osbplf.org, click on Loss Prevention, then click on ALERT.
2. For a copy of the policy statement issued by the Oregon Department of Revenue on January 14, 2002, visit www.osbplf.org, click on Loss Prevention, then click on ALERT.
3. See January 14, 2002 Policy Statement Regarding Administration of the Oregon Estate Tax.

Erratum

January 2002 Issue

Two incorrect statements appeared in the article "Educational Planning in the 21st Century" in the January 2002 issue. The author had updated the text during the production process, but the changes did not appear in the published version. The editor apologizes for these mistakes.

The article incorrectly states that a beneficiary of an UTMA account has control of the funds at age 18. ORS 126.869 provides that UTMA accounts must be distributed when the minor reaches age 21. Further, a change made by the 2001 Oregon legislature permits the original transferor to a UTMA account to authorize a delay in the distribution to the minor to a time specified between age 21 and 25. ORS 126.872.

In discussing section 529 plans, the article stated that distributed earnings are taxed at the student's rates. Effective January 1, 2002, distributions from a 529 plan are tax free if used for qualified educational expenses. A later effective date, January 1, 2004, applies to qualified tuition programs established and maintained by private eligible educational institutions.

October 2001 Issue

In the article "The IRS's New Proposed Rules for Required Minimum Distributions," in the October 2001 newsletter, references to the new uniform mortality tables should read as follows:

Page 5, paragraph D.1: After the owner's death, if there is an individual designated beneficiary, the MRD for the year of the owner's death uses the owner's life expectancy determined from the table being used before death — either the owner's single expectancy under the uniform table or, for a much younger spouse, the owner and spouse's joint expectancy from Table VI of Reg. 1.72-9. Prop. Reg. 1.401(a)(9)-5, A-4(a)(1).

Page 5, paragraph D.1.a: If the owner's spouse is the sole designated beneficiary, the distribution period during the spouse's life is the divisor listed in Table V of Reg. 1.72-9 corresponding to the spouse's attained age in the distribution year. Prop. Reg. 1.401(a)(9)-5, A-5(c)(2).

Page 5, paragraph D.1.b: If the designated beneficiary is not the owner's spouse, the distribution period in the year after the year of the owner's death is the divisor on Table V of Reg. 1.72-9 corresponding to the beneficiary's attained age in that year after death. Prop. Reg. 1.401(a)(9)-5, A-5(c)(1). For each succeeding year, the initial divisor is reduced by one.

Page 6, paragraph D.2.a: If the owner survives to the RBD, MRDs for the first year after the year of death are calculated using the owner's remaining life expectancy shown on Table V of Reg. 1.72-9, based on his or her age attained in the death year. Prop. Reg. 1.402(a)(9)-5, A-5(c)(3). For each succeeding year, the initial divisor is reduced by one.

The Exemption Increase: Why Some May Not Be Able To Give $1 Million Tax Free

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") created many uncertainties in developing estate planning strategies for clients with large estates. Should the one-year repeal of the estate tax be the basis for planning? Should a larger exempt amount and reduced tax rate be the only expected outcome? Or should we base plans on the sunset provision (2001 Tax Act § 901), which will restore the current level of gift and estate tax one year after the tax is repealed?

Amid all that confusion, one planning opportunity stands out. The amount that can pass tax-free under IRC § 2010(c) is now $1 million. This is a positive change in the estate and gift tax code that planners can put to work immediately.

Many taxpayers who have been aggressive in making gifts in the past will want to take advantage of the increase in the exempt amount to expand on their prior gift planning. Because the applicable exclusion amount rose by $325,000 to $1 million in 2002, these taxpayers should consider making large gifts in 2002 to use up their additional ability to make tax-free gifts. However, not all taxpayers can give an additional $325,000 tax-free in 2002. For those who have previously paid gift tax, careful calculation is needed to determine the largest gift that can be made without incurring additional gift tax.

Although the tax code refers to the "applicable exclusion amount" in IRC § 2010(c), the underlying basis for the calculation remains a tax credit. In 2001, the tax credit was $220,550. In 2002, the credit rose by $125,250 to $345,800. For taxpayers who have not made prior taxable gifts, the increased credit translates into an ability to give $1 million tax-free. Taxpayers who have previously paid gift tax, however, are in a higher gift and estate tax bracket. For them, the credit will shelter a smaller portion of any additional gifts.

For instance, assume that in 2000 the taxpayer made a taxable gift of $1.5 million and paid gift tax in the amount of $335,250. The taxpayer is now in the 45 percent gift and estate tax bracket. A credit of $125,250 at a 45 percent tax rate translates into a gift of $278,333, or $46,667 less than the announced increase in the applicable exclusion amount. If that taxpayer makes a $325,000 taxable gift to take advantage of the increase in the applicable exclusion amount, only part of the gift will be sheltered by the credit, and the taxpayer will owe $21,000 in gift tax.

Planners should calculate potential gift taxes before advising large taxable gifts. Failure to do so could result in an unpleasant surprise.

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CALENDAR OF SEMINARS AND EVENTS

- April 22-26, 2002 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, Plaza Hotel, New York City, NY. Telephone: (800) CLE-NEWS.
- April 25-26, 2002 (Sponsored by ABA-Section of Real Property Probate and Trust Law) **13th Annual Real Property and Estate Planning Symposia**, San Francisco, CA. Telephone: (312) 988-5262. On-line: www.abanet.org/rppt/spring2002.
- May 16-17, 2002 (Sponsored by PESI) **Ultimate Conference on Tax Planning with Retirement Assets**, Monte Carlo Resort & Casino, Las Vegas, NV. Telephone: (800) 826-7155.
- May 16-17, 2002 (Sponsored by PESI) **Ultimate Trust Workshop**, The Otesaga, Cooperstown, NY. Telephone: (800) 826-7155.
- May 30-31, 2002 (Sponsored by ALI-ABA) **Charitable Giving Techniques**, Marriott Copley Place, Boston, MA. Telephone: (800) CLE-NEWS.
- June 6-7, 2002 (Sponsored by PESI) **Estate Planning Techniques for Mid-Sized Estates**, The Sagamore, Bolton Landing, NY. Telephone: (800) 826-7155.
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- July 29 - August 2, 2002 (Sponsored by ALI-ABA) **Skills Training for Estate Planners (STEP)**, Emory University, Atlanta, GA. Telephone: (800) CLE-NEWS.
- August 1-3, 2002 (Sponsored by ALI-ABA) **Estate Planning for the Family Business Owner**, Cornado (San Diego), CA. Telephone: (800) CLE-NEWS.
- August 21-23, 2002 (Sponsored by ALI-ABA) **Basic Estate and Gift Taxation and Planning**, Boston, MA. Telephone: (800) CLE-NEWS.
- November 14-15, 2002 (Sponsored by the WSBA) **The 47th Annual Estate Planning Seminar**, Washington State Convention and Trade Center, Seattle, WA. Telephone: (800) 945-WSBA.

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