Newsletter

Ethical Wills and Legacy Planning

Why an Ethical Will?

Estate planning has long been regarded as an important legal function to ensure that the wishes of an individual in the disposition of his or her assets are expressed in a document that is legally sound, clearly understood, and reflects his or her intent. Today there is a growing awareness that in addition to the tangible, monetary assets that can be inherited, there are intangible, spiritual assets that also may be transmitted in the form of a will. These other assets are included in what has come to be called an "ethical will."

In an ethical will, an individual conveys to relatives and friends the values and perceptions that have been accumulated over a lifetime. The ethical will reflects achievements that have been attained, insights into dealing effectively and positively with the challenges of life, and the principles that are close to the heart of the individual. An ethical will recognizes that human beings have a profound need to feel that their lives have been meaningful and significant, particularly to those whom they deeply love and respect. Leaving behind only material goods does not adequately meet that need.

Only recently have workshops been conducted to enable experts in the field of estate planning to appreciate this special need of their clients and to learn how to address that need with sensitivity and with competence. In the wake of the September 11 tragedy, the American public was vividly exposed to the powerful impact of the legacy that ordinary heroes left to their families and to the community at large. Ethical-will workshops reveal that everyone is a hero, with an important legacy to bestow, if the document is properly developed and expressed. All human beings who have lived a full life have developed understandings and insights that possess enormous value to their loved ones. The challenge is to evoke those thoughts and frame them properly for the heirs. This shift in focus offers an extraordinary opportunity for the estate planner to realize the potential fulfillment of his or her professional mission.

For a historic perspective and examples of ethical wills, see Jack Riemer & Nathaniel Stampfer, editors, *So That Your Values Live On—Ethical Wills and How to Prepare Them* (Jewish Lights Publishing, 1991. *www.jewishlights.com*).

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Legacy Planning

Preparing an ethical will or "last thoughts and wishes"—same idea, different approach—is the central act in legacy planning, but it is only one part of a process. In essence, legacy planning is the spiritual dimension of estate planning, taking measures to ensure that one's values and heritage will be preserved for future generations. Other steps include drafting an obituary, specifying funeral and interment arrangements, offering guidance for a memorial service, providing a chronology of life events, documenting provenance of sentimental as well as marketable possessions, and explaining the personal meaning behind bequests and gifts. The monumental act of legacy planning is to record, in some form, one's life story or memoir.

Estate planning attorneys may well ask how their legal documents can serve these ends or why they should become advocates for a process that does not specifically call for their expertise or services. Some might assert that this process is more appropriately driven by a spiritual counselor or close family members.

A direct response is that an individual who has taken steps to prepare a will or estate plan, especially over a period of time, is more likely to have shared personal concerns with an attorney than with a minister or rabbi. Furthermore, most families are reticent to discuss death issues. Lawyers, family, and clergy, however, all feel the impact and consequences of lives that end without direction in spiritual or sentimental matters. Legacy planning, in turn, can inform legal documents.

The springboard for legacy planning is writing an ethical will or a letter setting out last thoughts and wishes. The distinction is fluid; there is no template for either. The concept of an ethical will emerges from religious values; a legacy letter is humanistic, focusing on life experience and lessons, remembering mentors and those with close ties, and saying "thank you." Encouraging a client to engage in this personal and soul-searching endeavor fosters empowerment and dialogue. Empowerment emerges from the process itself. By personally authoring three to five pages of final thoughts, one is forced to clarify what is essential and to weigh the meaning and impact of enduring words. The challenge of imparting such thoughts on paper also is likely to deepen the level of actual communication with those who will be affected. The word "love" inevitably enters here, as our nation was called to witness in final telephone messages from the victims of September 11.

In human affairs, emphasizing practical outcomes of one's search for meaning and affirmation of values may seem to be a contradiction. But legacy planning can be driven by practical considerations. The following examples are based on actual situations:

Obituary. Mrs. S, known best for her colorful personality, artistic family, and internationally recognized composer father, taught lute for 40 years at the Juilliard School, in New York City. Although long retired, she retained sharp wit and memory into her late 80s, at which time a nephew determined that her life story should be recorded to preserve her musical legacy and memories of her father. Artifacts of their respective careers, in the form of music scores, antique instruments, and correspondence with famous people, filled bookshelves and closets throughout her vast apartment. She expected that everything of musical value eventually would be sold to support an autistic son or donated to reduce taxes on her estate.

When Mrs. S died in her early 90s, her trustee, living in Oregon, turned to the personal historian to contact major newspapers for an obituary and to locate former associates for a memorial service. By that time, her father's reputation had increased but her career was mostly forgotten. However, The New York Times ran a feature-length obituary with a large press photograph showing her in Renaissance dress, playing her lute. The obituary brought her life and death to the attention of two people who became key figures in settling her estate: New York's most esteemed appraiser of music collections and a long-ago friend with a principal role in music acquisitions for the Library of Congress.

Bequests. Mrs. T, age 60, who has divorced and remarried, has arranged to leave 10 percent of her modest estate to various charities and institutions rather than to her children and grandchildren. Her will specifies these charitable gifts. Mrs. T understands that by the time of her death, she is likely to have grandchildren who could use the extra funds to meet college expenses. Mrs. T, anticipating that possibility, has attached to her "last thoughts and wishes" an explanation for each of her bequests, noting that the gifts honor and thank mentors and institutions who benefited her in some significant way. No one can be certain that the explanations will mitigate hard feelings, but Mrs. T takes comfort in affirming values that she wishes to impart to her descendants.

Memoir. Dr. R, age 65, will leave an estate of approximately $1 million, to be divided among three sons. A significant portion of that value is in a library of early 20th century phonodiscs, appraised 20 years ago for $200,000. Among the 6,000 recordings, some are worth hundreds or even thousands of dollars to other collectors, most are worth a few dollars, and others may find no buyer at all. The eldest son, who asked to have the collection in his part of the estate, now worries that keeping the collection will be too burdensome and he may want to sell the records as quickly as possible after his father's death. However, collectors who might be interested or could afford this library are as rare as the recordings themselves. Complicating the problem for the three sons is the fact that Dr. R's house, designed to provide optimal conditions for protecting and giving access to the phonodisc collection, will likely need to be sold in order to settle the estate. Due to difficulties in moving and properly storing the phonodiscs, being able to readily determine what to do with them after Dr. R's death will be important. With the guidance of a personal historian, Dr. R has written the story of how his collection came to be assembled, its organizing principles, and the provenance of significant items, as well as the interlocking of his interest in classical music with his father's influence. The memoir inspired lively conversation with his sons. The "story" of the collection offers the best hope that it might be sold intact or attract the interest of some institution. For a start, the memoir and record catalog can be circulated through the internet. The three sons, knowing the meaning of their father's achievement, are more likely to resolve the situation in a reasonable way.

No argument for the benefits of legacy planning can rest without issuing a caveat to every estate planning attorney: that first step, to write an ethical will or legacy letter, is not simple. By undertaking this mission for himself or herself, the estate planner will have a clearer understanding not only of the value, but also of the challenges encountered along the way.

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Charitable Planning with Retirement Assets

Introduction

This article discusses the rules related to charitable planning with distributions from retirement accounts. On April 17, 2002, the Treasury Department issued new Regulations that significantly affect planning in this area and that must be used by all taxpayers to calculate their required minimum distributions from retirement accounts beginning January 1, 2003. Charitable planning is easier and the options are more flexible under the new rules, but it is crucial to remember that the rules are still complicated. In addition to an understanding of the minimum distribution rules, charitable planning with retirement assets also requires a working knowledge of the rules related to planning for income in respect of a decedent. This article will first provide an overview of the rules relating to income in respect of decedents and then discuss the primary alternatives available for charitable planning with retirement assets.[1]

Income in Respect of a Decedent. Retirement account distributions are generally taxed as ordinary income to the account owner while the owner is alive. Income in respect of a decedent ("IRD") is property that if the decedent had received it before death would have been taxable income to the decedent. The Treasury Regulations define IRD as gross income "not properly includable in computing [the decedent's] taxable income for the taxable year ending with the date of [the decedent's] death." Treas Reg 1.691(a)-1(b). In other words, IRD assets are assets that contain untaxed ordinary income or deferred capital gain. When a beneficiary receives an IRD asset, the beneficiary must pay income tax on the asset at the rates applicable to the beneficiary (just as the deceased owner would have if he or she had recognized the income or gain during his or her life).

Examples of IRD items include installment sale payments, savings bonds, uncollected lottery winnings, annuity contracts, and retirement plan assets and distributions. Under current law, a person, while living, cannot make a gift of retirement assets to any person or charity without having to recognize the gift as taxable income on his or her income tax return. Of course, a donor will receive an income tax deduction for amounts given to charity. However, at the death of an account owner, retirement plan assets pass to another person or entity (the designated beneficiary) and distributions are taxed directly to the recipient.

If an IRD asset is paid to a person, the person must declare the income on his or her Form 1040 for the year it was received. If an IRD asset is paid to an estate or trust, the estate or trust must recognize the income on its Form 1041 for the year it was received. In addition, IRD assets are included at full value on a decedent's estate tax return. For that reason the person or entity who receives the IRD asset can take an income tax deduction for the amount of federal estate tax paid attributable to the IRD portion of the asset. IRC § 691(c). Because a public charity is by definition tax-exempt and will not pay income tax on IRD assets, retirement assets make a perfect gift to charity.

Fundamental Charitable Planning with Retirement Assets

Beneficiary Designations. The most straightforward way to transfer IRD assets (such as a retirement account) is through a beneficiary designation. When the account owner dies, the transfer is not made under the terms of a will or a trust created by the decedent, but rather in accordance with the beneficiary designation form. The beneficiary designation form is a binding contract between the account owner and the custodian of the retirement account, and the custodian is bound to distribute account proceeds in accordance with the contract after the account owner's death.

Beneficiary designations are a direct and simple way to distribute IRD assets to charity. Naming a charity directly is preferable to naming an estate or a trust as beneficiary on a designation form and using the IRD assets to satisfy a charitable bequest in a will or trust. In particular, satisfying a pecuniary bequest (one that names a specific sum or a formula that creates a specific pecuniary amount) with IRD assets could trigger recognition of income at the estate or trust level. For example, if an IRA names an estate as beneficiary and the estate then uses $100,000 of IRA assets to fund a pecuniary charitable bequest, the entire $100,000 will be subject to income tax at the estate level and the estate will not be eligible for an income tax charitable deduction. Treas Reg § 1.661(a)-2(f)(1).

Commentators have observed that a disproportionately low amount of retirement assets are left to charity. Planners should be aware that when it comes to dividing assets between charitable and noncharitable beneficiaries, it is usually more beneficial from a tax perspective to leave retirement assets to charity and nonretirement assets (stock, bonds, and real estate) to family members. Stock, bonds, and real estate all receive a stepped-up basis at death and therefore are "low tax" assets, while retirement assets result in IRD and are therefore "high tax" assets. Under the 2002 regulations, it is easier than ever to leave a retirement account or a portion of a retirement account to charity.

To increase planning flexibility, an account owner should consider designating a charity as a contingent beneficiary on a retirement account. Doing so would allow a primary beneficiary the opportunity to disclaim at the account owner's death so that all or a portion of the assets would pass to the contingent charitable beneficiary. The disclaimer would then enable the estate to benefit from a charitable estate tax deduction.[2] By providing an opportunity to disclaim to a charity, the primary beneficiaries will have the opportunity to make the most optimal choice under the circumstances that exist at the time of the account owner's death based on a family's needs, the size of the estate, and the estate tax laws in effect at that time. Note that the account owner should be confident that the primary beneficiary will carry out his or her wishes regarding the ultimate charitable beneficiary. In particular, a surviving spouse may treat the retirement account as his or her own retirement account and roll the account over into his or her own name and designate his or her own beneficiaries in place of the charitable beneficiary. If this is a concern to the account owner, then a charitable remainder trust may provide a better option (see discussion below).

Disposition Through a Will or Trust. It is almost always preferable to name a charity as a primary or contingent beneficiary of retirement assets directly on a beneficiary designation form rather than to provide the charity with a gift by will or trust. However, in cases in which there was no opportunity to do so, or in which it was simply not done and assets pass to the decedent's estate, it may be possible to distribute IRD assets to a charity if language in a will specifically authorizes the distribution.

The best (and most fail-proof) method would be for the drafter to specifically direct an in-kind distribution: "The balance of my Vanguard IRA Account No. xxxxx to the Oregon Zoo Foundation." Under Treas Reg § 1.691(a)-4(b)(2), the Oregon Zoo Foundation will recognize income from the IRD, but because the Oregon Zoo Foundation is a tax-exempt public charity, no tax will be due.

Another way to transfer IRD assets to charity through an estate is to have language in the will that specifically authorizes nonpro-rata distributions.

> Example: "My Personal Representative shall not be obligated to distribute each asset equally, but rather may make distributions in cash or in-kind (including non-pro-rata distributions) or partly in cash or partly in kind, and may distribute different assets to each beneficiary."

However, care must be taken in administering non-pro-rata distributions or IRD will have to be allocated to each share proportionally. *See* Natalie B. Choate, Life and Death Planning for Retirement 311-13 (4th ed 2001); *see also* Priv Ltr Rul 200234019 (May 13, 2002) for a favorable ruling on assigning retirement accounts to charity using the executor's non-pro-rata allocation powers and Treas Reg § 1.663(c)-5 example 9 (separate share regulations authorize allocation of IRD to charity's separate share when required by governing instrument).

Advanced Charitable Planning with Retirement Assets

Using Retirement Assets to Fund a Charitable RemainderTrust. For years, planners have told clients to keep assets in retirement accounts as long as possible in order to defer the recognition of income. Clients also like the idea of providing assets to family members to use for their own retirement. The disadvantages to maximizing retirement account deferrals are (1) the full value of the retirement plan assets are subject to estate tax, and if the estate has no liquidity, part of the assets may have to be withdrawn to pay the tax; (2) large accounts with large distributions will generate a significant amount of income tax for the children (up to 45 percent combined tax rate in some states); (3) when a designated beneficiary (e.g., a child) elects the fixed life expectancy option under the new minimum distribution rules there is a fair probability that the child will outlive the life expectancy distributions; and (4) despite an account owner's best intentions, a beneficiary may choose to clean out an account or accelerate distributions—thereby destroying the deferral advantage.

If maximizing the tax benefits of deferral is the primary objective of the client, then designating a spouse as beneficiary and allowing the spouse to roll over the account at death is clearly the best option. However, in situations in which there is no surviving spouse or a spousal rollover is unattractive to the account owner, naming a charitable remainder trust as a beneficiary of the account may present the best option for meeting the wishes of the client and maximizing tax deferral. If properly structured, a charitable remainder trust will entitle the estate to a charitable deduction, and a charitable remainder trust can "guarantee" payments for life for all beneficiaries. A charitable remainder trust works particularly well if there is a single older beneficiary (such as a sibling of an account owner) and a younger beneficiary (such as a child of that sibling).

The requirements for creating, funding, and maintaining a charitable remainder trust are outside the scope of this article. In essence, a charitable remainder trust is an irrevocable trust that pays annual income to a noncharitable beneficiary or Page 9 beneficiaries for life or a term of years with remainder to charity. The annual amount paid to the noncharitable beneficiary must either be a fixed amount (for a "charitable remainder annuity trust") or a fixed percentage of the value of the trust as determined annually (for a "charitable remainder unitrust"). A unitrust is a more flexible vehicle than an annuity trust, because a donor may add assets to a unitrust after it is funded. A unitrust also comes in a variety of flavors, including the "standard unitrust" (paying the annual percentage of assets only), a "net income unitrust" (paying the lesser of net income or the annual percentage), a "net income with makeup unitrust" (same as net income unitrust but with make-up provisions in later years if net income exceeds the annual percentage), or the "flip unitrust" (starts as a net income unitrust and flips to a standard unitrust on the occurrence of a specific event).

A charitable remainder trust is a tax-exempt entity. However, it has a specific four-tier accounting system under which assets that come into the trust retain their character on distribution. Distributions must be accounted for so that all ordinary income is paid out of the trust until exhausted. After ordinary income follows capital gain, then tax-exempt income, and finally principal. The result of this four-tier payout system is that, in general, the beneficiaries of a charitable remainder trust must pay ordinary income tax on distributions.[3]

The benefit of using a charitable remainder trust to hold retirement assets for a charity is that on distribution from the retirement account, the trust receives all of the retirement assets and pays no tax, so all of the assets can be used for investment purposes. None of the assets are consumed by tax as they would be if paid to a noncharitable beneficiary.

Making retirement benefits payable to a charitable remainder trust should not be undertaken lightly. Doing so requires in-depth substantive knowledge of retirement plan law, transfer tax law, fiduciary income tax law, and the tax laws that govern charitable giving. For a charitable remainder trust to work properly there must be the right combination of beneficiaries and ages; too many beneficiaries (more than three) will complicate matters and force the use of multiple separate charitable remainder trusts or a term unitrust. Above all, a practitioner should be sure that the client/donor's situation is appropriate for paying retirement assets to a charitable remainder trust.

Credit Shelter Unitrust. Several commentators, including Christopher R. Hoyt of the University of Missouri School of Law, have advocated using retirement assets to fund a credit shelter trust through the use of a charitable remainder unitrust. This vehicle has been dubbed the "credit shelter unitrust." Although this method appears to be advantageous under certain circumstances, it must be used carefully and will not outperform the "average" situation of an account owner leaving retirement accounts to a surviving spouse, followed by a spousal rollover. In a situation in which a spousal rollover is not an attractive alternative, however (such as in a second marriage or when there is no surviving spouse), a credit shelter unitrust trust may increase options and prolong payouts to account beneficiaries.

The credit shelter unitrust avoids many of the difficulties involved in trying to qualify payments to a trust for the marital deduction, as the marital deduction is not needed when funding the credit shelter amount. The credit shelter unitrust works well for second marriage situations in which a unitrust model is preferable to paying retirement assets to a QTIP trust. The credit shelter unitrust can also be a great tool for an account owner who wants to benefit nonspouse beneficiaries but has a retirement plan at a company that requires a lump sum payout to nonspouse beneficiaries at death. Aunitrust would allow the beneficiaries to defer income tax on most of the account rather than being hammered by tax in the year of the lump-sum distribution. The ideal credit shelter unitrust candidate is someone who needs to use retirement assets to fund a credit shelter trust, wants the trust to provide income over the lives of multiple beneficiaries, and wants to ultimately benefit a charity.

However, a charitable remainder credit shelter unitrust has drawbacks planners should consider. A unitrust will not work when the beneficiaries are too young, as the unitrust must qualify under the 10 percent remainder interest rule. A unitrust also cannot allow "emergency" distributions from principal, so it is not a good choice for a surviving spouse who has few other sources of support.

As with any charitable beneficiary, the best way to pay retirement assets to a unitrust is to name the unitrust as a designated beneficiary of the retirement plan. This will avoid triggering taxable income to the estate or individual beneficiaries. Under no circumstances should an estate be named as beneficiary with the intent of funding the unitrust through a probate.

The trickiest aspect of a charitable remainder credit shelter unitrust is drafting the beneficiary designation for the funding of the unitrust. If too few assets are distributed to the unitrust, the credit shelter amount will be wasted, while overfunding a unitrust will result in estate tax. In addition, the amount to be funded must be determinable at death in order to satisfy the estate tax charitable deduction rules. A fractional formula with a maximum cap of a specific dollar amount is generally the best solution. Further, when there is a surviving spouse who shares the same charitable goals as the account owners, disclaimers can also be used to fund the charitable remainder credit shelter unitrust, adding additional flexibility to the overall estate plan.

Using Retirement Assets to Fund a Gift Annuity. Using retirement assets to fund a gift annuity to a charity is currently an unsettled area of law requiring caution by planners advocating such structures. In Priv Ltr Rul 200230018 (Apr. 22, 2002), the IRS ruled somewhat favorably on a transaction in which a donor entered into a gift annuity agreement with a charity under which he agreed to give the charity the entire amount of his IRA assets at his death. The IRS ruled that the charity's exempt status will not be adversely affected by the transaction, nor will the charity realize unrelated business taxable income ("UBTI"). However, there are other issues that the IRS did not address in the ruling, including whether there would be taxable income to the beneficiary at the time the annuity contract became binding. The IRS also did not analyze how much of each annuity payment is taxable (presumably all unless the IRA was funded with aftertax dollars). Finally, the IRS did not comment on the issue it ruled unfavorably on in Priv Ltr Rul 199901023 (Oct. 8, 1998)—whether the § 691(c) deduction for IRD subject to estate tax would flow through to the annuitant.

Conclusion

Recent regulatory changes have increased the flexibility available to planners in using retirement assets to benefit charities, but the rules remain complex. Planners with clients wishing to benefit one or more charities with their retirement account assets should first consider naming the charities as beneficiaries, or contingent beneficiaries, of their accounts. If additional flexibility is required, or contingencies exist that mandate more complex planning, planners should consider the use of a charitable remainder trust, in one of many available formats, as a beneficiary of retirement account assets. Finally, as in all areas of complex estate and tax planning, advisors should remain alert for changes in the applicable laws and regulations that may affect their existing and future estate plans.

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[1] This article is by no means a comprehensive discussion of the complicated rules governing distributions from retirement accounts. For a general discussion of the workings of the new rules see Jonathan A. Levy, "The IRS Issues Final Rules for Minimum Required Distributions," Or Est Plan & Admin Sec Newsl at 1 (Oct. 2002), and for a complete analysis of the rules, see Natalie B. Choate, Life and Death Planning for Retirement (4th ed 2001).

[2] It is critical for tax purposes that a disclaimer be a "qualified disclaimer." Essentially, a qualified disclaimer must be in writing, it must be received by the executor of an estate within nine months after the date of the decedent's death, the person disclaiming the assets must not have accepted any benefits or interest in the property, and the interest must pass to a person or entity other than the disclaimant. IRC § 2518(b). This means that a disclaimer will be impossible if a beneficiary takes any action to roll over or claim retirement benefits before deciding to disclaim.

[3] To add to the four-tier tax pain, the IRS has ruled that distributions from a charitable remainder trust are net of the § 691(c) deduction ordinarily allowed to persons or entities that receive IRD assets that were subject to estate tax. This means that under most circumstances, an individual beneficiary of a charitable remainder trust will never receive the benefit of the § 691(c) deduction. As a result, it will likely not make sense from a tax perspective to fund a charitable remainder trust with retirement assets when estate tax is due on those assets.

Oregon Inheritance Tax Update: HB 2184

Oregon has generally been characterized as a "pick-up tax" state since January 1, 1987, meaning that the Oregon inheritance tax liability equals the amount allowed as the state death tax credit on the federal estate tax return. However, Oregon does not automatically track with the changes made to the federal law for purposes of calculating the Oregon inheritance tax (as it does for purposes of calculating the Oregon income tax). So the increases to the federal estate tax credit scheduled under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") do not automatically apply for purposes of calculating a taxpayer's Oregon inheritance tax liability. However, after EGTRRA passed, many began to question to which year the Oregon statutes were tied and whether the Oregon Department of Revenue ("the ODR") was properly assessing and collecting the Oregon inheritance tax. Two questions surfaced:

- What is the threshold estate value that triggers the requirement to file and pay Oregon inheritance tax under state law?
- What estate tax credit value should be used for purposes of calculating Oregon inheritance tax under state law?

After EGTRRA passed, ODR determined that it had some problems with the Oregon inheritance tax statutes (ORS chapter 118) – particularly in regard to interpretation of ORS 118.160 ("Federal Filing Requirement") and ORS 118.010 ("Tax Rate Requirement"). Oregon's inheritance tax statutes do not reference a specific date for purposes of "tying in" to the federal estate tax statutes. After a review of the legislative history, it was determined that these statutes were tied to the federal estate tax law as of April 28, 1997. Additionally, although ORS 118.160 specifically requires the filing of an Oregon inheritance taxreturn only when a federal estate tax return is required, there is no provision affirming that no Oregon inheritance tax is due if no return is required.

Except for the decisions by the ODR as to how it would administer and collect the Oregon inheritance tax, very little has happened in the last 18 months. On October 25, 2002, Governor Kitzhaber vetoed HB 4077, which was the only attempt in the last legislative session to resolve any of Oregon's inheritance tax disconnect issues. In response to the veto, the ODR issued an updated inheritance tax advisory that can be downloaded at *http://www.dor.state.or.us/taxInfo/Inhtaxadv.html*.

With respect to tax years 1998 through 2001, the ODR warned that estates that had filed Oregon inheritance tax returns that presumed the state statute was tied to the changes made under the federal Taxpayer Relief Act of 1997 may owe additional tax, depending on legislative action taken in respect to these years, and that estates should retain sufficient funds to cover that possibility.

For decedents dying in 2002, the ODR established that Oregon inheritance tax would be calculated using a $600,000 estate tax credit value but decided that taxpayers who are not required to file a federal estate tax return will not be required to file or pay tax an Oregon inheritance tax. In essence, the ODR determined that the state legislature never tied state provisions to the changes made under the federal Taxpayer Relief Act of 1997, but decided to give a free pass to taxpayers with estates between the Oregon inheritance tax threshold and the $1 million federal estate tax threshold to avoid the complexity of having to prepare and administer a new Oregon inheritance tax return for estates between $600,000 and $1,000,000.

With respect to the 2002 tax year the advisory stated:

"What about estates for deaths that occurred after January 1, 2002?

> "It is clear that the Oregon Legislature did not adopt the federal inheritance tax changes in the Economic Growth and Tax Relief Reconciliation Act of 2001.

"How do I file my 2002 return?

> "The form is available on our website at *http://www.dor.state.or.us/2002Forms/103-001.pdf* * * * * * *. It calculates the Inheritance tax based on a tie to federal law prior to the 1997 federal changes. You are not required to file an Oregon Inheritance tax return if you are not required to file a federal Inheritance tax return.

The first inheritance tax bill introduced in the 2003 legislative session was HB 2184, ordered printed by the Speaker (at the request of Governor Ted Kulongoski for the ODR). It seeks to remedy the statutory confusion for years 1998 through 2002 and tie 2003 to the federal estate tax law as it existed on December 31, 1996. The bill may be downloaded at *http://www.leg.state.or.us/03reg/measures/hb2100.dir/HB2184.intro.html*. As of March 12, three other bills have been introduced in the House. This article focuses on HB 2184, but the discussion highlights some of the practical dilemmas that will serve as a benchmark for the issues that must be resolved for current tax law and the future tax law as well. The article concludes with a brief look at the highlights of the three additional bills.

The summary to HB 2184 reads:

> "For purposes of determining Oregon inheritance tax, applies changes made to federal estate tax law to decedents who died during 1998 to 2002 period. States that no Oregon inheritance tax is due if federal law, as of certain dates, does not require filing of federal estate tax return. *Does not alter effect of existing law for estates of decedents who die on or after January 1, 2003*.
>
> "Authorizes Department of Revenue to assess unpaid inheritance taxes in same manner as unpaid income taxes are assessed." (Emphasis added.)

Before getting into the details of the bill, it is helpful to compare the "existing law" for estates of decedents and the "existing policy" adopted by the ODR. Based on the advisory statements from the ODR, the existing policy for determining Oregon inheritance tax is a two-step process:

- First, Oregon inheritance tax is due only if a federal estate tax return was required to be filed (Federal Filing Requirement) (ORS 118.160). In 2002 this meant that the estate had to have a gross value over $1 million (including "adjusted taxable gifts," if any) requiring the filing of a federal estate tax return[1]. If an estate had an adjusted value of $1 million or less, no Oregon inheritance tax was due. It is interesting to note that the ODR is following the changes made by EGGTRA in administering this part of the law for 2002.
- Second, if a federal estate tax return was required to be filed, Oregon inheritance tax is calculated based on the lesser of the estate tax due based on the applicable exclusion amount and the state death tax credit (Tax Rate Requirement). In 2002, this is the lesser of the estate tax due, based on a $600,000 applicable exclusion (a credit of $192,800), or the state death tax credit (ORS 118.010) as defined under federal law in effect on April 28, 1997.

In contrast, section 7 of HB 2184 indicates that "existing law" for the filing requirement means "[a]n inheritance tax return is not required with respect to the estates of decedents unless a federal estate tax return is required to be filed under the Internal Revenue Code, as amended and in effect on *December 31, 1996*." (Emphasis added.) In other words, it is the view of the Oregon Legislative Counsel's Office (the authors of HB 2184) that both the Federal Filing Requirement and the Tax Rate Requirement are tied to the federal estate tax law as it existed on April 28, 1997, or December 31, 1996 ("IRC-96"), assuming that the federal estate tax law was the same on both of those dates.

If section 7 of HB 2184 is a correct statement of "existing law," then an Oregon inheritance tax is due for every estate over $600,000 since January 1, 1998. In other words, every estate over $600,000 in value was required to file an Oregon inheritance tax return and pay the required amount of the Oregon inheritance tax. But the ODR has not taken this approach since January 1, 1998 and has instead followed a policy that has been more favorable for taxpayers. For example, an estate in 2002 with a gross value of more than $600,000 but less than $1 million owes no Oregon inheritance tax because no federal estate tax return is required to be filed. The interpretation of "existing law" under HB 2184, on the other hand, would require a federal estate tax return to be filed based on IRC-96 and Oregon inheritance tax to be paid.

A reason that the ODR has not followed the $600,000 filing requirement is a practical one. The ODR would have to develop a new inheritance tax return to cover estates valued between $600,000 and the amount of the federal exemption. In addition to the administrative burden of preparing and administering a new tax form, there is the very significant issue of how to determine whether people who are not required to file a federal estate tax return are complying with Oregon law. The ODR does not have sufficient staff or administrative regulations to locate and ensure compliance by estates over $600,000 that are not required to file a federal estate tax return. For this reason, the ODR has remained closely aligned with the federal estate tax return filing requirement, since it ensures a significant degree of compliance and is easy to administer.

Because the State Death Tax Credit (IRC §2011) is being repealed and the credit against estate taxes is being increased (IRC §2010), the legislature can no longer tie to the federal statutes without losing significant Oregon inheritance tax revenue. If the legislature decides to step away from the federal estate tax system and adopt some kind of stand-alone system, an effective means of insuring compliance will have to be developed.

The state legislature and Governor Kulongoski now have an opportunity to clarify these issues and indicate exactly which Internal Revenue Code "tie-in" dates are applicable. HB 2184 was introduced to correct and ratify a number of ODR policies that have been applied for tax years 1998 through 2002. In addition to ratifying current ODR policies, HB 2184 provides two additional clarifications.

First, in analyzing whether the statute of limitations had run for any of the tax years 1998 through 2002, it was discovered and then confirmed by the ODR that there is no statute of limitations provision applicable to ORS chapter 118. An ODR spokesperson indicated that, as a policy matter, the ODR has been applying the three-year statue applicable to income tax returns (ORS 314.410) to the Oregon Inheritance Tax returns even though there is no reference to ORS chapter 314 in any of the statutes in ORS chapter 118. The statute of limitations question is resolved by section 9 of HB 2184, which ties the assessment and collection activities under ORS chapter 118 to the income tax provisions under ORS chapter 314.

Second, ORS 118.160 currently provides that no Oregon inheritance tax return will be required unless a filing a federal estate tax return is required. However, there is no provision in the statute stating that no tax is due if no return is required. As a matter of policy, the ODR has determined that if a federal estate tax return is not required, then no Oregon inheritance tax is due. Sections 4, 5, and 7 of HB 2184 correct this omission.

For tax years 1998 though 2002, the provisions of HB 2184 are revenue neutral and ratify the policies that have been followed by the ODR. For 2003 and the years that follow, section 7 of HB 2184 will increase the amount of Oregon inheritance tax collected, because it will require estates over $600,000 to file an Oregon inheritance tax return (as opposed to the current $1 million level).

In light of Oregon's current budget crisis, it is unlikely that the Oregon inheritance tax will be repealed, even though the Oregon inheritance tax represents a very small percentage of total state revenue. Since the State Death Tax Credit will be repealed in 2005, the legislature must adopt new, stand-alone statutes that are not tied to the current federal estate tax changes if it is going to continue to collect Oregon inheritance tax revenue.

Finally, married couples with taxable estates will continue to face a dilemma that is not addressed by HB 2184. If the decedent spouse uses the federal exemption amount, currently $1 million, with a credit shelter trust, the surviving spouse is faced with a $33,200 Oregon inheritance tax bill. If the credit shelter trust is funded to the Oregon exemption equivalent of $600,000, the heirs of the surviving spouse may have to pay substantially more than $33,200 in federal estate taxes when the surviving spouse dies. Historically, no federal or state estate tax has been due when the first spouse dies. A state Qualified Terminal Interest Property ("QTIP") election would resolve this issue by providing a structure that could allow an Oregon inheritance tax to be deferred when the first spouse dies and at the same time allow the credit shelter trust to be funded with the full federal exemption amount.

If the Oregon legislature decides to maintain Oregon inheritance tax revenue at or near the current level, the legislature will have to step away from the federal estate tax return filing requirement. It will be helpful if any legislation addressing these issues, including HB 2184, includes the relevant tie-in date, specifies Oregon tax rates and exemption amounts without tying them to federal statutes, authorizes the ODR to prepare tax return forms and adopt the necessary administrative rules, and authorizes a state QTIP election.

As of March 12, 2002, three additional bills have been introduced to the legislature: HB 2503 (eliminates the Oregon inheritance tax beginning on January 1, 2004), HB 2704 (similar to HB 4077 passed in the last special budget session, eliminates the Oregon inheritance tax beginning January 1, 2005), and SB 632 (ties 1998 through 2001 to the Taxpayer Relief Act of 1997, ties 2002 and future years to EGTRRA and repeals the Oregon inheritance tax beginning on January 1, 2005). HB 2704 and SB 632 provide a remedial solution for tax years 1998 through 2004 and then repeal the Oregon inheritance tax on January 1, 2005. HB 2503 does not address any of the 1998 through 2003 remedial issues, but simply repeals the Oregon inheritance law on January 1, 2004 and deletes any references to "Chapter 118" or "inheritance tax" in approximately 17 other statutes.

All of these bills (except for HB 2184) provide for the repeal of the Oregon inheritance tax in either 2004 or 2005. No bill introduced thus far provides a workable stand-alone inheritance tax program for 2003 and beyond. Recently, Senator Randy Miller, a co-sponsor of HB 2503, spoke to the House Revenue Committee and indicated that the Oregon inheritance tax should be repealed because it results in property being taxed twice and is a very burdensome tax. The final legislative decision about repealing or not repealing inheritance taxes will depend on whether or not these taxes are selected to carry any of the burden of generating revenue for the state. If inheritance taxes are selected as one of the continuing revenue options, a "stand-alone" inheritance tax structure will have to be adopted.

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[1] Please note that the "filing requirement" (currently $1,000,000) includes "adjusted taxable gifts" which were made during the decedent's lifetime. Therefore, it is possible for an estate to have a date of death value less than $1,000,000, but because of the amount of the "adjusted taxable gifts," the filing of a federal return is still necessary, and it is possible that an Oregon inheritance tax will be due.

Posthumously Conceived Heirs

Is a posthumously conceived child an intestate heir? Three states have answered this question: New Jersey and Massachusetts with a qualified yes and Arizona with a no. In all three cases the underlying concern involved qualification for Social Security benefits and not the distribution of an intestate estate, but each court's decision focused on whether the state's intestacy statute would treat the child as an heir of the decedent.

In each of the cases a husband stored frozen sperm before undergoing treatment for cancer. After the husband's death, his widow used artificial insemination or in vitro fertilization to become pregnant. In each of the cases, twins were born to the mother, who then applied for Social Security benefits. Because qualification for Social Security benefits depends on status under a state's intestacy law, the courts had to address that issue.

In the New Jersey case, *In re Estate of Kolacy*, 753 A2d 1257 (NJ Super Ct Ch Div 2000), the court noted that the statute did not address issues created by changes in reproductive technology. The judge found a general legislative intent that children should be able to inherit from and through their parents. For that reason, the judge determined that if a child proved that he or she was genetically the child of the parent then the child should be considered an heir "unless doing so would unfairly intrude on the rights of other persons or would cause serious problems in terms of the orderly administration of estates." *Id.* at 1261. The court suggested that some time limits would be appropriate. The court held that two girls born 18 months after their genetic father's death qualified as heirs.

In the Massachusetts case, *Woodward v. Commissioner of Social Sec*., 760 NE2d 257 (Mass 2002), the court concluded that a child conceived posthumously could be a child under the intestacy statute if the child and parent were genetically related and if the deceased parent had affirmatively consented to the posthumous conception and support of any resulting child. The court indicated that time limits could preclude a claim, although the court did not specify a time limit. In *Woodward* the children were born two years after their father's death. The court held that they qualified as intestate heirs.

The most recent case comes from Arizona. In that case, *Gillett-Netting v. Barnhart*, 231 F Supp 2d 961 (D Ariz 2002), the court noted that under the Arizona intestacy statute a child was one who survived the decedent or was "in gestation" at the time of decedent's death. The court concluded that in order to "survive" a decedent a person must be alive at the decedent's death, with an exception for after-born children *in gestation* before the decedent's death. Therefore, said the court, a child who was not conceived until after the decedent's death could not be an heir.

Although the Arizona court focuses on the use of the term "in gestation" in the Arizona statute, court decisions in other states may not turn on the presence or lack of that term. Most intestacy statutes were adopted before posthumous conception was a possibility. Even in states that have altered their statutes more recently, no legislative history suggests that the legislatures have considered the status of posthumously conceived children. Thus the approach taken by courts in other states facing this issue will likely depend more on the court than on the particular wording of a statute.

The New Jersey and Massachusetts cases both suggest that a child born too long after the parent's death will not be an heir, but neither case creates a bright-line rule. Massachusetts adds a requirement that the child, or the proponent for the child, prove that the deceased parent consented to the posthumous conception. As the courts in the three cases state, the problem is one better left to legislatures, but if the legislatures do not act the courts will have to make a determination.

For estate planners, the interpretation of an intestacy statute is significant for the construction of wills and trusts. If a document does not provide an adequate definition, a court will look to state law to determine the meaning of terms like "child" and "descendant." In Oregon, ORS 112.195 specifically states that those terms will include "any person who would be treated as so related for all purposes of intestate succession" unless the will, trust, or other instrument establishes a contrary intent. And the judge in *Kolacy* noted that one reason a determination of their status as heirs was important for the two girls in that case was that "[t]heir status as his heirs could also be significant in determining their rights under the wills of their father's relatives." Kolacy, 753 A.2d at 1260.

For estate planners, clarifying the intent of the testator or the grantor of a trust takes on new significance. A typical will form might define children to include "any child born to or adopted by me, before or after my death." As in the intestacy statutes, the form's intent is presumably to include children in gestation before the parent's death. With the developments in assisted procreation, the possibility of posthumous conception or the existence of frozen embryos at death should be considered at the drafting stage. At a minimum, the documents could provide a time limit for a birth of a child after the death of a parent. Children in gestation should not be excluded in an attempt to address posthumous conception, but leaving open the possibility that a child born many years after a parent's death could alter the distribution of an estate or trust is not likely to carry out a client's intent.

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CALENDAR OF SEMINARS AND EVENTS

- April 14, 2003 (Sponsored by OSB Estate Planning and Administration Section, OSB Agricultural Law Section, Willamette University College of Law, and Oregon State University College of Agricultural Sciences) **Farm Estate Planning by Dr. Neil Harl.** Salem, OR. Telephone: (503) 370-6877.
- April 28 - May 2, 2003 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates.** New York, NY. Telephone: (800) CLE-NEWS.
- May 14-17, 2003 (Sponsored by Natl. Institute for Estate Planners) **National Institute for Estate Planners Seminar.** Las Vegas, NV. Telephone: (877) 267-9482.
- May 29-30, 2003 (Sponsored by ALI-ABA) **Charitable Gifting Techniques.** Chicago, IL. Telephone: (800) CLE-NEWS.
- June 4, 2003 (Sponsored by PLI) **International Tax & Estate Planning 2003: Strategies & Techniques for Maximum Advantage.** New York, NY. Telephone: (800) 260-4PLI.
- June 15-20, 2003 (Sponsored by ALI-ABA) **Estate Planning in Depth.** University of Wisconsin Law School, Madison, WI. Telephone: (800) CLE-NEWS.
- June 18-21, 2003 (Sponsored by Natl. Institute for Estate Planners) **National Institute for Estate Planners Seminar.** San Diego, CA. Telephone: (877) 267-9482.
- July 7-11, 2003 (Sponsored by ALI-ABA) **Skills Training for Estate Planners (STEP)—Session One.** Atlanta, GA. Telephone: (800) CLE-NEWS.
- July 10-12, 2003 (Sponsored by ALI-ABA) **Estate Planning for the Family Business Owner.** Boston, MA. Telephone (800) CLE-NEWS.
- July 17-18, 2003 (Sponsored by ALI-ABA) **Representing Estate and Trust Beneficiaries and Fiduciaries.** Chicago, IL. Telephone: (800) CLE-NEWS.
- July 28-31, 2003 (Sponsored by ALI-ABA) **Skills Training for Estate Planners (STEP)—Session Two.** Atlanta, GA. Telephone: (800) CLE-NEWS.
- July 30-August 1, 2003 (Sponsored by ALI-ABA) **Basic Estate and Gift Taxation and Planning.** Santa Fe, NM. Telephone: (800) CLE-NEWS
- August 21-22, 2003 (Sponsored by ALI-ABA) **International Trust and Estate Planning.** Coronado, CA. Telephone: (800) CLE-NEWS.
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- October 23-25, 2003 (Sponsored by Southern California Tax & Estate Planning Forum) **The 23rd Annual Southern California Tax & Estate Planning Forum.** San Diego, CA. Telephone: (800) 322-3755 www.cle.net
- October 30-31, 2003 (Sponsored by Washington State Bar) **The 48th Annual Estate Planning Seminar.** Seattle, WA. Telephone: (800) 945-WSBA.
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