Newsletter

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Proposed Legislation on Death of a Protected Person

ORS chapter 125 contains extensive provisions on the appointment of guardians and conservators and their duties with respect to a living protected person. However, it gives little guidance on their duties after the death of the protected person.

One short section, ORS 125.530, is devoted to the duties of a conservator after the death of a protected person. Most of that section deals with the duties of the conservator respecting a will, leaving one vague sentence on what else the conservator is supposed to do: "The conservator shall retain and administer the estate for delivery to the personal representative of the decedent or other persons entitled to the estate." *Id.*

ORS 125.475(1)(a) requires that the conservator file with the court an accounting within 30 days after the death of the protected person.

ORS 125.230 provides:

> "(1) Except as provided in subsection (3) of this section, a fiduciary's authority terminates upon the * * * protected person's death. * * *
>
> "* * * * *
>
> "(3) A guardian retains the authority to direct disposition of the remains of a deceased protected person if the guardian is unaware of any contact during the 12-month period immediately preceding the death of the protected person between the protected person and any person with priority over the fiduciary to control disposition of the remains under ORS 97.130 or to make an anatomical gift under ORS 97.954."

The Oregon Court of Appeals noted in *Herburger v. Herburger*, 144 Or App 89, 94, 925 P2d 103 (1996), that "when a protected person dies, the conservator's once broad powers are constricted to delivering the will and retaining the estate until the court's order of termination." The court of appeals in *Naito v. Naito*, 125 Or App 231, 864 P2d 1346 (1993), allowed the court in a protective proceeding to approve post-death payment of administration expenses, but the statutory provision on which that decision was based was deleted in the 1995 revision of ORS chapter 125. The court's authority in protective proceedings is now limited under ORS 125.095(1) to approving payment of fees from "[f]unds of the protected person." At the moment of death, title to all assets of the protected person passes from the protected person to heirs or devisees, subject only to administration by a personal representative. ORS 114.215. There are no longer funds from which the court can approve payment of fees.

In This Issue

My experience, particularly with escheat estates, is that this lack of guidance tends to hobble attorneys who are advising conservators on how to proceed after the death of a protected person. Escheat tends to be a once-in-a-lifetime experience for most attorneys, and few are aware of the notification requirement previously found in administrative rules. In 2003, the legislature added to ORS 113.238 the requirement that the conservator notify the Department of State Lands within 48 hours of learning that the protected person died without a will and without known heirs. It is not at all unusual for conservators and their attorneys to mull over the situation for six to eight months before (usually) attempting to initiate probate with the former conservator as personal representative. When this happens, the petition will either be denied or the personal representative will be removed, because under ORS 113.085(2) only the Department of State Lands can administer such probate estates.

The Executive Committee of the Estate Planning and Administration Section has approved proposed legislation to give better guidance to fiduciaries on the death of a protected person. Under the bill, the following changes would be made in the law:

- The conservator would be allowed 30 days instead of 48 hours to notify the Department of State Lands of the death of a protected person with no will and no known heirs.
- Administration expenses in the protective proceeding would be given priority for payment from the deceased protected person's estate under ORS 115.125, after medical expenses and before state taxes. Administration expenses are currently general claims with the lowest priority.
- The court in the protective proceeding would be authorized to approve fees for payment from funds held by the fiduciary or from the probate estate. If the fees are paid from the probate estate, the fees of the fiduciary or attorney approved in the protective proceeding would be treated as claims reduced to judgment, which generally cannot be contested in the probate proceeding. A conservator would be authorized to withhold funds from a personal representative to pay court-approved fees
- The conservator's final accounting would be due 60 days after the death of the protected person, rather than 30 days.
- ORS 125.530 would be amended to conform to ORS 112.810(1)(f) regarding delivery of a will in the possession of a fiduciary.
- New provisions would expressly require a conservator to give appropriate notice within 30 days to all known persons who succeed to conservatorship property, including the person nominated to be personal representative under a will or beneficiaries named in a will, heirs if there is no will, the Department of State Lands for escheat estates, beneficiaries under insurance policies or retirement plans, and joint owners.
- A conservator would be authorized to deliver estate assets to a personal representative or other successor without court order, and a personal representative or other successor could directly petition the court in the protective proceeding to release restrictions imposed on the assets in lieu of a bond.
- A guardian would be required to file a report of death in the protective proceeding within 30 days after the death. If no conservator has been appointed, the guardian must give notice of the report to the persons to whom a conservator would have been required to give notice.

This bill, if enacted, will provide clear guidance for fiduciaries concerning their duties after the death of the protected person.

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Evidentiary Issues in Estate Claims: Claimant Testimony Rule

Statutory History

The earliest laws of Oregon, enacted in 1862, provided that a claim against an estate could be presented on the "affidavit of the claimant" and, if "doubted" by the executor or administrator, would be determined by a referee whose report had the same effect as a court order made in an action or suit upon the claim. General Laws of Oregon ch 15, §§ 1101-02 (Deady & Lane 1843-72), 1105-06 (1866); Semple Code §§ 1101-02, 1105-06 (1874). No restriction on the proof of a disallowed estate claim appeared in these early statutes.

The law of estate claims changed in 1885 as the Oregon legislature grew more sympathetic to the position of the decedent's estate. Section 1701 of the Deady Code was amended to declare "not admissible" the testimony of a person who was "[a] party to an action or suit by or against an executor or administrator"—a classic "Dead Man's Statute." Or 1885 Laws at 106. At the same time, section 1102 of the Deady Code was enlarged to describe how estate claims that had been disallowed should be handled. Courts were empowered to hear and reject or allow "all demands against any estate,"

> "*[p]rovided*, That no claim which shall have been rejected by the executor or administrator, as aforesaid, shall be allowed by any court, referee or jury, except upon some competent or satisfactory evidence other than the testimony of the claimant." Gen Laws Or 1885 at 45 (emphasis in original).

The quoted language was the first appearance of the Claimant Testimony Rule. The Rule, which limits the effect of a claimant's testimony, was superfluous so long as the Dead Man's Statute (which prohibits a claimant from testifying at all) was in force. Section 1102 soon emerged from the shadow of redundancy, however, when the Dead Man's Statute was repealed in late 1885. Gen Laws Or 1885, special session, at 32. Since then, a party whose estate claim has been disallowed has been permitted to testify, but the sufficiency of the party's evidence has been determined under the Claimant Testimony Rule.

After 1885, the Claimant Testimony Rule was codified successively in Hill's Annotated Laws of Oregon § 1134 (1887); I Codes and Statutes of Oregon, tit XVI, ch V, § 1161 (Bellinger & Cotton 1902); Lord's Oregon Laws § 1241 (1910); Oregon Laws § 1241 (Olson 1920); Oregon Code Annotated § 11-504 (1930) ("or" between "competent' and "satisfactory" deleted, as result of Gen Laws Or 1929, ch 244, § 1); and Oregon Compiled Laws Annotated ("OCLA") § 19-704 (1940).

In 1949 the legislature split OCLA § 19-704, which by then had grown to the size of a small essay, into a number of shorter sections. The last two clauses of OCLA § 19-704, although not logically related, were placed together in a new subsection, OCLA § 19-704(h). OCLA § 19-704(h) prohibited the allowance of time-barred claims and provided:

> "No other claim which shall have been rejected by the executor or administrator shall be allowed by any court except upon some competent, satisfactory evidence other than the testimony of the claimant." Or Laws 1949, ch 477, § 9.

As a result of the 1949 legislation, "court, referee or jury," a phrase that had been part of the Claimant Testimony Rule for 64 years, was shortened to the single word "court."

In 1953 the above-quoted language was recodified as ORS 16.555. In 1969 it was again recodified as ORS 115.195 and further restated by transferring the negative from the subject to the verb:

> "A claim that has been disallowed by the personal representative may not be allowed by any court except upon some competent, satisfactory evidence other than the testimony of the claimant." Or Laws 1969, ch 591, § 159.

The Claimant Testimony Rule has appeared in this form for the last 35 years, finally expressed as a separate statute.

General Principles

Over 60 reported Oregon decisions discuss the Claimant Testimony Rule. The statute was applied frequently in its early years, beginning with *Morrison v. McAtee*, 23 Or 530, 32 P 400 (1893). The most recent Oregon Supreme Court decision discussing the Rule is *Lawrence v. Ladd*, 280 Or 181, 572 P2d 638 (1977). Since *Lawrence* was decided, the Rule has been applied in nearly a dozen Oregon Court of Appeals decisions. The holdings in those decisions have not materially expanded on previous jurisprudence.

ORS 115.195 does not render an estate claimant incompetent as a witness. *Estate of McLain*, 126 Or 456, 463, 270 P 534 (1928); *In re Steele's Estate*, 152 Or 49, 56, 52 P2d 207 (1935). The purpose of the statute, instead, is to withhold full effect from the survivor's testimony when the other party to a dispute is dead. *In re Hattrem's Estate*, 170 Or 613, 632, 135 P2d 777 (1943).

Simply put, ORS 115.195 requires a party whose claim against an estate has been disallowed to make out a prima facie case (i.e., a case sufficient to sustain a verdict on the claimant's behalf) independent of the claimant's testimony. *Re Estate of Banzer*, 106 Or 654, 656, 213 P 406 (1923); *Seaton v. Security S. & T. Co.*, 131 Or 261, 268, 282 P 556 (1929); *In re Millon's Estate*, 154 Or 615, 617-18, 61 P2d 1030 (1936). Having presented other evidence to lay the foundation for a recovery, the claimant may reinforce that evidence with his or her own testimony, thus rendering it more probable that the trier of fact will find in the claimant's favor. *Uhler v. Harbaugh*, 110 Or 609, 616, 224 P 89 (1924).

These general principles and the wording of ORS 115.195 raise a number of application issues, some of which are unresolved.

Application Issues

Claims That Are Not Against an Estate. The Claimant Testimony Rule is part of ORS chapter 115, which deals with claims that are filed "against" an estate, as opposed to claims that are filed "to" an estate. According to the Oregon Supreme Court, the Rule does not apply to the latter type of claim. *Harris v. Craven*, 162 Or 1, 18, 91 P2d 302 (1939); *see also Willbanks v. Goodwin*, 70 Or App 425, 430, 689 P2d 1004 (1984). Thus the Rule does not apply to proceedings to enforce a contract to make a will or devise under ORS 112.270; proceedings to contest the validity of a will under ORS 113.075; or proceedings to recover an elective share under ORS 114.105, *et seq*.

Claims That Are Not Disallowed. ORS 115.195 applies only to estate claims that have been "disallowed." The statute therefore does not apply to claims that may reduce the distributable value of an estate but do not follow the ORS chapter 115 claim presentation and allowance/disallowance procedure. Among such proceedings are those initiated by a petition for temporary or permanent support under ORS 114.015, et seq.; petition for approval and award of the personal representative's fee under ORS 116.173; petition for approval and payment of attorney fees incurred by the personal representative under ORS 116.183; and, most strikingly, claims against an estate presented by the personal representative under ORS 115.105. *See Re Estates of Bethel*, 111 Or 178, 186, 209 P 311, 226 P 427 (1924). Because a personal representative's claims are exempt from the Claimant Testimony Rule, a real incentive exists for a creditor to be appointed personal representative under ORS 113.035, and for a personal representative who is a creditor to resist removal under ORS 113.195.

An action pending on the date of the defendant's death may be continued against the decedent's estate without presentation of the underlying claim. ORS 115.315. Because the underlying claim in such a situation is never "disallowed," the lawsuit is not subject to the Claimant Testimony Rule. In light of this, counsel for a party whose testimony cannot be corroborated should consider filing suit before a foreseeable date of death.

Claims That Are Not Allowed by a Court. As noted above, the Claimant Testimony Rule was amended in 1949 to cover only claims "allowed by any court," and not claims "allowed by any * * * referee or jury." Without the benefit of legislative history, it is unclear whether the change in wording was intended to reduce the types of proceedings to which the Rule applies. A claimant may argue that the Rule in its present form does not apply in proceedings tried to a jury, an additional reason to prefer separate action over summary determination of a claim. *See* ORS 115.145(1). A personal representative, on the other hand, may argue that the term "court" in ORS 115.185 embraces all claims proceedings, since it is the trial court that enters judgment even on a jury verdict. No reported case has addressed this issue.

Nonclaimant Parties Who Testify. ORS 115.195 requires only the testimony of a "claimant" to be disregarded. Legal entities and natural persons have both been given some maneuvering room to avoid that status. The testimony of employees in support of a corporation's claim against an estate has been held not to be the testimony of a claimant within the meaning of ORS 115.195. *Mason, Ehrman & Co v. Lewis Est.*, 131 Or 242, 259-60, 276 P 281, 281 P 123, 282 P 772 (1929). Similarly, a creditor may be able to offset against monies owed to a decedent, or take possession of property in dispute, thereby causing the personal representative to be the party initiating the legal action. *See Waite v. Grubbe*, 43 Or 406, 414, 63 P 206 (1903) (claim to property, taken after decedent's death by defendant as gift to which she was entitled before decedent's death, was not considered claim against estate of donor for purposes of Claimant Testimony Rule).

Testimony That Does Not Trigger Policy Concerns. Language in opinions such as *Banzer* and *Seaton* seems to suggest that a claimant must establish every element of his or her case—duty, breach, causation and injury—on the basis of legally sufficient evidence other than testimony of the claimant. Other decisions, particularly those involving implied-contract actions for the reasonable value of services rendered, have followed less exacting standards. *See Lawrence*, 280 Or at 192 n 13. Thus it has been held that a claimant's testimony of nonpayment does not have to be corroborated. *Estate of Kukas,* 120 Or 542, 544-45, 252 P 947 (1927); *Littlepage v. Security S. & T. Co.*, 137 Or 559, 560-61, 3 P2d 752 (1931) (testimony sufficient, on ground that payment is affirmative defense that personal representative must establish). It has also been held that a claimant's testimony of the reasonable value of services does not have to be corroborated. *Franklin v. Northrup*, 107 Or 537, 552-54, 215 P 494 (1923) (testimony sufficient, on ground that damage evidence was equally available to personal representative, and opinion evidence is "[c]learly * * * not within the mischief sought to be prevented by the statute"). In light of these cases, there is room to argue that if a claimant's testimony concerns an element of his or her case as to which the absence of the decedent does not disadvantage the estate *(e.g.*, a claimant's testimony concerning medical expenses or pain and suffering), ORS 115.195 should not apply.

Practice Considerations

Although in a number of situations ORS 115.195 may not apply, within its domain the statute is lethal. Oregon case law is replete with cases wherein a directed verdict in favor of an estate was affirmed or a trial court judgment in favor of a claimant was reversed, on Claimant Testimony Rule grounds. Counsel for a claimant should bear the statute in mind when assembling and preparing witnesses and should inform the client of attendant risks if witnesses other than the claimant cannot be found. Conversely, counsel for the personal representative should be sure to (a) depose a claimant carefully on the issue of liability, with the goal of eliminating other witnesses; (b) refrain from doing anything to alert a claimant to the existence of the other-witness issue; (c) request that the trial or summary determination of a claim be reported in order to have a record from which to argue; and (d) move at the close of the claimant's evidence, if appropriate, for a verdict and judgment in favor of the personal representative on the ground that the claimant's evidence, other than the claimant's own testimony, is legally insufficient to establish one or more of the necessary elements of the claim.

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Unitrust Conversion and Power to Adjust Under Oregon's Uniform Principal and Income Act

Many trustees and beneficiaries are aware that there are options to change existing trusts under Oregon law. There are new principal and income allocation options available to a trustee under the 2003 Oregon Principal and Income Act (the "2003 Oregon Act"). The trustee has a new power to adjust between income and principal or to convert an income interest. There are other options available to the trustee that preexist the 2003 Oregon Act. First, there can be an agreement authorized under ORS 128.177 among the trustor, trustee and beneficiaries to modify the trust in a manner consistent with any dominant purpose or objective of the trust. Second, the trustee or beneficiary may petition a court under ORS 128.135 to issue an order modifying the trust in a manner consistent with any dominant purpose or objective of the trust.

Background: Reaction to Uniform Prudent Investor Act

The 2003 Oregon Act is based on the 1997 Uniform Principal and Income Act (the "1997 UPIA"), which states in a Prefatory Note that one of its two purposes is to enable fiduciaries to successfully implement the investment principles embodied in the Uniform Prudent Investor Act, including in particular the modern principle of investing for total return rather than for a certain level of income. In essence, the 2003 Oregon Act, like the 1997 UPIA, is intended to allow a trustee to deviate from traditional income and principal allocation rules when such rules do not allow the trustee to invest as a modern prudent investor and still implement the trustor's intent regarding the balance between the interests of income and remainder beneficiaries. When deviation from traditional income and principal allocation rules is necessary, the specific tool the 1997 UPIA provides to reallocate portfolio return is the power to adjust between income and principal. As explained below, Oregon (which enacted the Oregon Uniform Prudent Investor Act-based on the Uniform Prudent Investor Act-in 1995, *see* ORS 128.192 to 128.218) adds to the power to adjust a power to convert an income interest to a unitrust interest.

2003 Oregon Act

As indicated above, the 2003 Oregon Act provides two major new tools to trustees administering trusts that provide for mandatory or discretionary income distributions: (1) a power to adjust between income and principal, and (2) a power to convert an income interest to a unitrust interest. Exercising these powers can, of course, have tax consequences.

Power of Adjustment. The 2003 Oregon Act follows the 1997 UPIA in providing trustees, under certain circumstances, with a power to adjust between income and principal. Specifically, under ORS 129.215, a trustee may adjust between principal and income, to the extent the trustee considers necessary, if:

- The trustee invests and manages trust assets as a prudent investor;
- The terms of the trust describe the amount that may or must be distributed to a beneficiary, by referring to the trust's income; and
- The trustee determines, after applying the rules in ORS 129.210(1) (concerning administering the trust in accordance with the trust terms and the 2003 Oregon Act), that the trustee is unable to comply with ORS 129.210(2) (concerning impartial trust administration with regard to income and remainder beneficiaries).

Invest and Manage as Prudent Investor. Most trustees in Oregon are likely to meet the requirement of investing and managing trust assets as a prudent investor, as that is the default investment regime to which the trustee is subject under Oregon law unless a trust's terms materially depart from the default rules. Pursuant to the Oregon Uniform Prudent Investor Act enacted in 1995, *see* ORS 128.192 to 128.218, a trustee must invest and manage trust assets as a prudent investor would. *See* ORS 128.196, 128.194. However, the act provides that trust provisions may expand, restrict, eliminate or otherwise alter the default prudent investor rule. ORS 128.194(2). Absent specific elimination of the prudent investor rule, the issue becomes whether any of the trust's investment and management provisions have the effect of overriding the defaults to such an extent that the trustee can no longer be considered as investing and managing the trust assets as a prudent investor.

Income Distributions. Each trust must also meet the requirement that an amount that may or must be distributed to a beneficiary refers to the trust's income.

Unable to Comply with Impartial Trust Administration. A trust must also meet the third requirement for exercising a power of adjustment: the requirement that the trustee must determine, after applying the rules in ORS 129.210(1), that the trustee is unable to comply with ORS 129.210(2). ORS 129.210(1) in essence provides that a trustee shall administer a trust in accordance with the 2003 Oregon Act if the terms of the trust do not differ from the Act or do not give the trustee a discretionary power of administration, in which case the trustee shall follow the trust terms or may exercise the discretionary power. ORS 129.210(2) in turn requires that the trustee shall administer a trust impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust clearly manifest an intention that the trustee shall or may favor one or more of the beneficiaries. The Comment to 1997 UPIA § 104 indicates that this third requirement for exercise of the power of adjustment is met when a trustee, administering the trust pursuant to ORS 129.210(1), determines that (1) to the extent that the trust does not require partiality, the trustee is unable to comply with the duty to administer the trust impartially, or (2) to the extent that the trust requires or permits partiality, the trustee is unable to achieve the degree of partiality required or permitted.

Essentially, the above standard requires the trustee to evaluate whether administering the trust in accordance with its terms and with the 2003 Oregon Act is preventing the trustee from being able to administer the trust impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the trust terms clearly manifest an intention to favor one or more of the beneficiaries.

However, the 2003 Oregon Act further requires that in deciding in each particular instance whether and to what extent to exercise the power of adjustment, the trustee must consider "all factors relevant to the trust and its beneficiaries," including, to the extent relevant, nine specified factors: (1) the nature, purpose and expected duration of the trust; (2) the trustor's intent; (3) the identities and circumstances of the beneficiaries; (4) the needs for liquidity, regularity of income and preservation and appreciation of capital; (5) the assets held in the trust, including whether they were contributed by the trustor; (6) the net amount allocated to income (without considering the power to adjust) and the change in value of principal assets; (7) the trust's terms regarding principal invasion and accumulation of income; (8) the actual and anticipated effect of economic conditions on principal and income; and (9) the anticipated tax consequences of adjustments. *See* ORS 129.215(2). Using the power to adjust would thus require the trustee to continually evaluate the issues involved.

Conversion to Unitrust. As an alternative to the power to adjust, the 2003 Oregon Act provides two methods for converting a trust to a unitrust. Under the first method, the trustee (unless expressly prohibited from doing so by the trust terms) may release the power to make adjustments and convert the trust into a unitrust if the trustee determines that (1) conversion will allow the trustee to more accurately carry out the intent of the settlor and the purposes of the trust, and (2) operation of the trust as a unitrust is consistent with the duties of the trustee under ORS 129.210(2) (regarding impartial trust administration). *See* ORS 129.225(2)(a). The trustee must give written notice of the conversion to all income beneficiaries and all beneficiaries who would receive distributions of principal if the trust were to terminate immediately. ORS 129.225(2)(b). If a beneficiary objects in writing within 60 days after notice, the trustee cannot convert the trust to a unitrust under this method. ORS 129.225(2)(c). Under the second method for converting the trust to a unitrust, the trustee or any beneficiary may file a petition seeking a court order directing the conversion. *See* ORS 129.225(3). Similar to the requirements placed on the trustee under the first method, in order to direct that the trust be converted, the court must conclude that (1) the conversion will enable the trustee to more accurately carry out the intent of the settlor and the purposes of the trust and (2) the operation of the trust as a unitrust is consistent with the duties of the trustee under ORS 129.210(2).

If the trustee determines that these standards are met and converts each trust to a unitrust, all trust provisions relating to income distributions will be construed to refer to an annual unitrust distribution equal to 4 percent of the fair market value of trust assets, averaged over the three preceding calendar years. *See* ORS 129.225(4)(b). In addition, after conversion, the trustee is expressly required to invest the trust assets as a prudent investor and follow an investment policy seeking a total return for trust investments, whether the return is derived from appreciation of principal or from earnings on and distributions from principal. *See* ORS 129.225(4)(a); cf. ORS 129.210(1) (requiring, among other things, trustee to invest as prudent investor in order to be able to use power to adjust).

The final regulations revising the definition of "income" under IRC § 643(b) and making conforming amendments to regulations affecting, among other things, trusts that qualify for the estate tax marital deduction and trusts that are exempt from generation-skipping transfer ("GST") taxes provide significant safe harbors to trustees converting an income interest to a unitrust interest under state statutes such as the 2003 Oregon Act. *See* Definition of Income for Trust Purposes, 69 Fed Reg 12 (Jan. 2, 2004).

Tax Consequences

Marital Deduction. One of the eligibility requirements for making a qualified terminable interest property ("QTIP") election under IRC § 2056(b)(7) is that the surviving spouse must have a qualifying income interest for life, which in part requires that the surviving spouse must be entitled to all of the income from the property, payable annually or at more frequent intervals, or have a usufruct interest for life in the property. *See* IRC § 2056(b)(7)(B). Converting a surviving spouse's income interest to a unitrust interest raises the issue of whether the unitrust interest meets the requirement that the spouse be entitled to all the income. Applicable for trusts for taxable years ending after January 2, 2004, the Treasury Regulations provide that a surviving spouse's interest in a trust meets the requirement that the spouse be entitled to all of the income, if the spouse is entitled to "income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of [Treasury Regulation] § 1.643(b)-1." Treas Reg § 20.2056(b)-5(f)(1); *see* Treas Reg § 20.2056(b)-7(d)(2) (providing that income requirements of Treasury Regulation § 20.2056(b)-5(f), which addresses power-of-appointment trusts, apply to QTIP trusts); Treas Reg § 20.2056(b)-10 (regarding regulation effective dates).

Treasury Regulation § 1.643(b)-1 in turn continues to define "income" as the amount of income of a trust for the taxable year, as determined under the terms of the governing instrument and applicable local law, except that trust provisions that depart from traditional principles of income and principal are generally not recognized. However, applicable for taxable years ending after January 2, 2004, Treasury Regulation § 1.643(b)-1 provides the safe harbor that allocations of amounts between income and principal pursuant to applicable local law will be respected "if local law provides for a reasonable appointment between the income and remainder beneficiaries of the total return of the trust for the year." With regard to unitrust provisions in particular, the regulation specifically states that a state statute providing that income is a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of the trust's assets is a reasonable apportionment of the total return of the trust. Since all provisions of a trust relating to income are construed to refer to a 4 percent unitrust distribution when a trust is converted to a unitrust under ORS 129.225, Oregon's unitrust percentage falls within the stated range and thus provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust. If the trustee converts a QTIP trust to a unitrust under the provisions of the 2003 Oregon Act, therefore, the trust should still be considered as providing the surviving spouse with all the income for life, for purposes of qualifying for the estate tax marital deduction.

Capital Gains. Converting a beneficiary's income interest to a unitrust payment also raises the issue of whether such action triggers realization of gain or loss because it constitutes a sale or exchange of property and the property received is materially different from the property given up. *See* Treas Reg § 1.1001-1(a). To address this issue, Treasury Regulation § 1.643(b)-1 now provides that a switch between methods of determining trust income, if authorized by state statute, will not constitute a recognition event for purposes of IRC § 1001. As indicated in the Summary of Comments and Explanation of Revisions accompanying the release of the final regulations in 69 Federal Register 12, the state statute's requirements for switching between methods must be followed in order for the conversion to qualify for the section 1001 safe harbor. Based on Treasury Regulation § 1.643(b)-1, if the trustee complies with the requirements of ORS 129.225 for converting the trust to a unitrust, such conversion will not trigger realization of gain or loss.

GST Issues. In general, trusts that are "grandfathered" (by virtue of being irrevocable on September 25, 1985) and thus exempt from the GST tax will not lose their grandfathered exempt status as a result of a trust modification, if (1) the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person(s) who held the interest before modification, and (2) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust instrument. *See* Treas Reg § 26.2601-1(b)(4)(i)(D)(1). Although no controlling authority exists, the Internal Revenue Service has indicated that trusts that are exempt from GST tax because sufficient GST exemption is allocated to the trust ("zero-inclusion trusts"—the type of trusts at issue here) should also retain exempt status after similar modifications or actions. *See*, *e.g.*, PLR 200141024 (July 11, 2001) (indicating that, at minimum, zero-inclusion trust should not lose exempt status under the same circumstances as grandfathered trust would not lose exempt status).

Conversion of an income interest in a trust to a unitrust distribution raises the possibility that a trust's GST-exempt status is at risk because conversion could result in distributions to the income beneficiary that are less than the amount of the trust's accounting income, which could have the effect of shifting a beneficial interest from the lifetime income beneficiary to a lower-generation remainder beneficiary. The final regulations alleviate this concern by providing a safe harbor as follows:

> [A]dministration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) * * * will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter. Treas Reg § 26.2601-1(b)(4)(i)(D)(2).

As under the marital deduction analysis, conversion of a trust to a unitrust under ORS 129.225 should qualify for this safe harbor because ORS 129.225 provides for a unitrust payment of 4 percent, which is a rate that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust. *See* Treas Reg § 1.643(b)-1. Thus, to the extent, if any, that modifications to zero-inclusion trusts can place such trusts' exempt status at risk, conversion of the trusts to unitrusts should not cause them to lose exempt status.

Overall, conversion to a unitrust under the 2003 Oregon Act is the exact type of action for which the final regulations are intended to provide substantial certainty as to tax consequences, including safe harbors to preserve the marital deduction, avoid triggering gain or loss and preserve GST-exempt status.

Conversion Under ORS 128.177 or ORS 128.135

The final regulations afford substantial protection to unitrust conversions made pursuant to statutes such as the 2003 Oregon Act. In contrast, the final regulations intensify the uncertainty of unitrust conversions made pursuant to an agreement among interested parties or to a court order, even if such agreement or court order is made pursuant to authority granted in a state statute such as ORS 128.177 or ORS 128.135. There are safe harbors for the marital deduction, capital gains tax and GST tax for conversion under the 2003 Oregon Act, but not for conversions (such as one to a unitrust at 3 or 5 percent, for example) under the other trust amendment statutes. As a result, practitioners should be very cautious about the tax consequences of such a conversion.

Practical Considerations

The new rules regarding unitrust conversion and power to adjust described in this article recently became available, in addition to the existing trust modification procedures. Once this happened, trustees and beneficiaries began asking whether it is possible—or desirable—to apply these procedures to existing trusts. Following are some of the real-life situations in which this question can arise:

A Dispute Between a Stepparent and Stepchildren. A stepfather is the lifetime beneficiary of a trust established by his late wife. He feels that the trust is not invested in a way that pays him enough income. Is a unitrust conversion a good idea? Oregon's unitrust conversion statute provides for a conversion to a 4 percent unitrust. What if the trustee or remaindermen feel that is too high of a payout? Some commentators believe this may erode the remainder value, particularly given that any trustee fee after conversion is also paid out of principal. For the remainder to keep pace with inflation, the investments would need to outperform a 4 percent return, plus the trustee's fee and any other principal expenses, plus inflation. The parties may then ask if it is possible to choose a percentage other than 4 percent. It is not possible under the unitrust conversion statutes, but under the general trust modification statutes it is possible for state-law purposes. However, the marital deduction may be lost, for the reasons discussed above.

A GST-Exempt or Grandfathered Trust. A lifetime beneficiary of a GST-exempt or grandfathered trust may wish he or she had more access to the trust's funds. The trustee (or the beneficiary) might think a unitrust conversion would be a good way to provide some predictability in trust distributions and reduce pressure on the trustee to distribute more. For the reasons stated above, this might erode the remainder value, which is not the usual goal of establishing and preserving a GST-exempt trust. Moreover, given that the stated goal of a GST-exempt trust is usually to maximize the amount passing to future generations, it is usually possible to invest funds so as to pay out less than 4 percent to an income beneficiary. Thus a unitrust conversion could increase the payouts to nonskip persons and minimize the eventual payout to skip persons.

The parties may then ask if we could amend the trust, by mutual consent, to pay out a lesser amount, such as 2 percent. Such a lesser payout would be possible under Oregon law by using the consent trust amendment procedure, but the safe harbor for unitrust conversion would not apply. As a result, there might be gain recognition under *Cottage Savings Assn. v. Commissioner*, 499 U.S. 554 (1991) or even a partial loss of GST exemption.

These examples are not meant to discourage using the unitrust conversion. Rather, they underscore that conversions should be done only after the lawyer does research and the clients consider the advantages and disadvantages.

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What's New

Betz v. Ganos, 196 Or App 5, 100 P3d 756 (2004)

Betz v. Ganos is a reminder of the importance of knowing procedural rules. Ganos and Lewis were appointed personal representatives of the estate of Wanda Costanzo. They sent notice to Wanda's heirs and devisees and published notice to interested parties on February 27, March 6, and March 13, 2002. On December 6, 2002, Betz, Wanda's stepdaughter, filed a petition contesting the admission of the will, alleging that Betz was a devisee under a prior will and claiming that the will admitted to probate was invalid because it had not been properly attested by two witnesses. Betz's petition was filed more than four months after the first publication of notice, and therefore was time-barred unless she could establish that she was entitled to notice by mail. ORS 113.075.

ORS 113.145(1) requires a personal representative to deliver or mail notice of probate to "persons described in ORS 113.035(8)." ORS 113.035(8) describes persons who, "so far as known" by the personal representative, contest the validity of a will. Betz failed to allege in her petition that the personal representatives knew of her claims. As a result, the trial court found that Betz had failed to allege facts sufficient to indicate that she was an interested person entitled to mail notice.

After an *in camera* hearing on the matter, Betz attempted to file an amended petition, but she filed it after the period allowed for amendment as a matter of right and did not obtain the consent of the opposing party or seek permission from the court as required by ORCP 23 A. The amended petition was therefore rejected by the trial court. On the personal representatives' motion, the trial court dismissed the will contest as being time-barred. Finally, Betz complained that the trial court had dismissed the action prematurely, because, she claimed, under local rules she had a period of time in which to respond to the motion to dismiss. The court of appeals pointed out that the judgment of dismissal was entered after the response period had elapsed and noted that Betz had not in fact filed a response.

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OREGON UNIFORM TRUST CODE

The Oregon Uniform Trust Code will be introduced in the 2005 Oregon Legislature as SB 275. The goals of the bill are to provide a reasonably comprehensive framework for the operation and administration of trusts in general, maintain and reflect the status of current Oregon law where that law is developed, and adhere to national uniformity where possible. A copy of the bill has been posted on the Oregon State Bar website at <*http://www.osbar.org/pubaffairs/pac.html*>. The bill can be found by scrolling down to Estate Planning Section Proposals. Also posted are two documents explaining the bill and the changes it makes to Oregon law.

Questions, Comments or Suggestions About This Newsletter?

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CALENDAR OF SEMINARS AND EVENTS

- January 16-23, 2005 (Sponsored by National Law Foundation) **2005 Mid-Winter Tax and Estate Planning Conference**, The Buccaneer Beach and Golf Resort, St. Croix, U.S.V.I. Telephone: (302) -656-4757.
- January 21, 2005 (Sponsored by the Estate Planning Council of Portland) **34th Annual Estate Planning Seminar**, Oregon Convention Center, Portland, OR. Telephone: (503) 205-2653.
- January 24-26, 2005 (Sponsored by The Law School University of Southern California Law School) **2005 Tax Institute**, Wilshire Grand Hotel, Los Angeles, CA. Telephone: (213) 740-2582.
- January 28, 2005 (Sponsored by Washington State Bar Association) **Elder Law Issues in Estate Planning**, Seattle, WA. Telephone: (800) 945-WSBA.
- February 10-11, 2005 (Sponsored by ALI-ABA) **Representing Estate and Trust Beneficiaries and Fiduciaries**, Astor Crowne Plaza, New Orleans, LA. Telephone: (800) CLE-NEWS.
- February 17, 2005 (Sponsored by Washington Sate Bar Association) **Estate Planning for Large Estates: Family Limited Partnerships and Beyond**, Seattle, WA. Telephone: (800) 945-WSBA.
- February 24, 2005 (Hosted by Oregon Law Institute) **Advanced Estate Planning Practice Update – Winter 2005**, Gus J. Solomon Courthouse, Portland, OR. Telephone: (503) 768-6580.
- March 4, 2005 (Sponsored by Oregon Law Institute) **Elder Law**, Oregon Convention Center, Portland, OR. Telephone: (503) 768-6580.
- March 9-11, 2005 (Sponsored by ALI-ABA) **Advanced Estate Planning Techniques**, Maui, HI. Telephone: (800) CLE-NEWS.
- March 18, 2005 (Sponsored by Washington State Bar Association) **Trusts and Estate Litigation**, Seattle, WA. Telephone: (800) 945-WSBA.
- April 18-22, 2005 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, Plaza Hotel, New York, NY. Telephone: (800) CLE-NEWS.
- June 19-24, 2005 (Sponsored by ALI-ABA) **Estate Planning in Depth, Madison**, WI. Telephone: (800) CLE-NEWS.
- June 27-July 1, 2005 (Sponsored by ALI-ABA) **Skills Training for Estate Planners (STEP)-Session One**, Atlanta, GA. Telephone: (800) CLE-NEWS.
- July 13-15, 2005 (Sponsored by ALI-ABA) **Estate Planning for the Family Business Owner**, Boston, MA. Telephone: (800) CLE-NEWS.
- July 18-21, 2005 (Sponsored by ALI-ABA) **Skills Training for Estate Planners (STEP)-Session Two**, Atlanta, GA. Telephone: (800) CLE-NEWS.

New Estate Planning Section Officers

The Section elected members of the 2005 Executive Committee at the Section meeting on November 19, 2004. The Section also approved officers for the coming year.

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