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Conflicts of Interest Involving Third Parties

This article is the last in a series of six articles discussing conflicts of interest. Prior articles dealt with conflicts of interest *between clients* and conflicts *between lawyer and client*. This article focuses on a third type of conflict: one which arises from the lawyer's relationship with *third parties who are not clients*.

The potential for conflicts involving third parties is relatively high in the field of estate planning and administration. The lawyer often deals with third parties who are not clients (such as trust officers, accountants, life insurance agents, and investment advisers) and naturally wants to develop and maintain mutually beneficial professional relationships. Nonlawyers may render estate planning advice and then ask the lawyer to cooperate in implementing a client's proposed estate plan. In addition, on occasion the lawyer is engaged (and perhaps paid) by one family member to prepare another's estate plan. In all of these situations, the lawyer must be aware of the potential for ethical problems to develop.

The disciplinary rules most likely to be called into play by the lawyer's relationship with third parties are DRs 5-108(A) and (B), which are intended to ensure that the lawyer is not influenced by a third party in exercising independent professional judgment on behalf of the client:

(A) Except with the consent of the lawyer's client after full disclo-

sure, a lawyer shall not:

(1) Accept compensation for the lawyer's legal services from one other than the lawyer's client; or

(2) Accept from one other than the lawyer's client anything of value related to the lawyer's representation of or the lawyer's employment by the lawyer's client.

(B) A lawyer shall not permit a person who recommends, employs or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.

A lawyer's relationship with third parties may also raise ethical questions under the following disciplinary rules:

DR 2-103, prohibiting *indirect solicitation of clients* through third parties.

DR 3-101(A), prohibiting a lawyer from *aiding a nonlawyer in the unauthorized practice of law*.

DR 3-102(A), prohibiting a lawyer from *dividing legal fees with a nonlawyer*.

DR 3-103, prohibiting a lawyer from forming a *partnership with a nonlawyer* if any of the partnership activities consist of the practice of law.

DR 5-108(D), prohibiting a lawyer from practicing in a *professional corporation* or association authorized to practice law for a profit, if a *nonlawyer* owns an interest, is a corporate director or officer, or has the

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right to direct or control the lawyer's professional judgment.

In many situations, more than one of these rules will apply to the lawyer's conduct.

A number of Oregon cases and ethics opinions address the ethical issues covered by these disciplinary rules. Following are examples of some of the situations which are likely to arise in an estate planning and administration practice, together with suggestions as to what the lawyer should do to avoid ethical problems.

The Client Referred By a Family Member

Occasionally, the lawyer is engaged (and perhaps paid) by one family member to represent another. For example, wealthy parents may want estate planning done for their children, or a child may want estate planning done for an elderly parent. In such a situation, the lawyer must be mindful of the requirements of DR 5-108. If a third party will pay the bill, before proceeding the lawyer must make full disclosure of the lawyer's relationship with the third party and the potential impact of that relationship on the representation, and must obtain the client's consent. The lawyer should also make clear that he or she will be representing only the client, must exercise independent judgment in advising the client, and must meet with the client outside the presence of the other family member.

Referrals From Other Professionals

Many estate planning clients are referred to a lawyer by another professional who is a member of the estate planning "team". Quite likely, the lawyer has worked with the professional before and considers him or her a valuable source of future referrals. The lawyer's relationship with the referring professional is most likely to raise two kinds of ethical problems.

The first problem involves the lawyer's ethical duty to exercise independent professional judgment on behalf of the client. Sometimes, the referring professional has already recommended that the client take certain estate planning steps. For example, a life insurance agent may have recommended that life insurance be purchased or a split-dollar life insurance plan be adopted. In such a situation, the lawyer is required by DR 5-108 to meet with the client personally, make an independent assessment of the client's needs, and make estate planning recommendations accordingly. See Oregon

Ethics Op. 3 (1936), involving clients referred to a lawyer by a trust company for preparation of wills (lawyer must be free to advise properly concerning desirability of a will, choice of fiduciaries, and desirability of a trust).

The second problem involves the ethical prohibition against indirect solicitation. Under DR 2-103, a lawyer may not request a third party, or give anything of value to a third party, to recommend or promote the use of the lawyer's services, and may not permit a referring party to influence the lawyer's independent professional judgment. While reciprocal referrals are a likely result of good professional working relationships, the lawyer must be cautious about efforts aimed at increasing referral business. Contrast Oregon Ethics Op. 316 (1976) (lawyer may ethically join a bona fide civic or service organization even if one result is to promote the lawyer's business through referrals) with Op. 439 (1980) (joining an informal business association formed solely to promote each member's business through mutual referrals is unethical).

Referrals From Interested Organizations

Similar considerations apply when a client is referred to the lawyer by some organization which may have a vested interest in the estate plan chosen by the client. In such a situation, DR 5-108 requires the lawyer to make an independent assessment of the client's needs and objectives and ensure that the estate plan selected represents the client's wishes.

In Oregon Ethics Op. 457 (1981), for example, representatives of a religious organization attempted to "oversee" estate planning of members for church institutions, supplying the lawyer with a completed questionnaire "together with the proposed estate plan and distribution". The opinion held that a lawyer may not ethically participate in such an arrangement. The lawyer's first obligation is to consider whether a will is desirable at all. Moreover, the danger exists that a lower fee may be quoted, or proposed bequests to church organizations will be approved, in order to maintain the business-generating relationship with the organization. See also Oregon Ethics Op. 99 (1961) (nonprofit retirement home required every resident to have a will and offered services of a lawyer to "check" or prepare residents' wills).

Business Arrangements With Nonlawyers

As already noted, nonlawyer professionals often play an important role in the estate planning process as part of the estate planning "team". Nonlawyers may also ask a lawyer to enter into a more formal arrangement to cooperate in providing estate planning services to clients. The lawyer must, of course, avoid unethical solicitation and exercise independent professional judgment on behalf of the client. But the lawyer must be concerned about other ethical restrictions as well.

The chief danger in this situation is that the lawyer will violate the disciplinary rules directed at the unauthorized practice of law by a nonlawyer. Several Oregon cases, as well as two ethics opinions, illustrate the dangers of ethical violations in the estate planning field.

Oregon State Bar v. Miller & Co., 235 Or. 341, 385 P.2d 181 (1963), involved a corporation, Executive Estate Planners, Inc., formed by a life insurance agent to provide financial and estate planning services to clients. The court enjoined the defendants from giving "suggestions" about ways to minimize taxes, finding that the corporation was giving legal advice in violation of state statutes prohibiting the unauthorized practice of law. See also *Oregon State Bar v. Gilchrist*, 272 Or. 552, 538 P.2d 913 (1975) (not unauthorized practice to sell do-it-yourself divorce kits, but nonlawyers may not counsel with or give advice to customers), and *Oregon State Bar v. Securities Escrows, Inc.*, 233 Or. 80, 377 P.2d 334 (1962) (unauthorized practice for escrow agent to draft or select real estate documents when discretion must be exercised to meet the needs of a particular customer).

Two Oregon ethics opinions explore the ethical obligations of lawyers who are asked to assist nonlawyers in providing estate planning services to clients.

In Oregon Ethics Op. 447 (1980), an "advisory group" was formed by an accountant, a financial planner, a life insurance agent, and a casualty insurance agent to provide financial and estate planning advice to individuals and businesses. The advisory group wished to designate a "recommended attorney" to whom referrals could be made if the client did not have a regular attorney to implement estate planning recommendations. The opinion found that participation in such an arrangement may violate the ethical rules prohibiting indi-

rect solicitation of clients and aiding a nonlawyer in the unauthorized practice of law. See also Oregon Ethics Op. 488 (1983) (divorce mediation service involving both attorneys and counselors must comply with rules prohibiting the practice of law with nonlawyers).

Oregon Ethics Op. 523 (1989) involved a foreign corporation which marketed an estate planning service in Oregon through sales representatives. The purchase agreement signed by customers obligated the corporation to evaluate the customer's estate planning needs, select appropriate planning methods, and draft documents. The corporation further agreed to obtain local counsel for the limited purpose of reviewing the documents for compliance with Oregon law and having them executed, in exchange for a fixed fee. Citing DRs 3-101, 2-103, and 5-108, the opinion held that a lawyer may not ethically participate in such an arrangement because doing so would aid a nonlawyer in the unauthorized practice of law and require the lawyer to accept restrictions in reviewing and analyzing the customer's estate planning needs.

Like the preceding articles in this series, this article is intended to help the practicing lawyer recognize and avoid conflicts of interest. The first article in this series, published in April 1989, began by emphasizing the importance of conflicts of interest. As the series concludes, the opening words of that article bear repeating:

"Conflicts of interest present the most complex and difficult ethical problems for the practicing lawyer. Today, merely being honest or well-intentioned is not enough. As increased attention is focused on conflicts of interest, courts are becoming less tolerant of lawyer ignorance and insensitivity. The lawyer who fails to recognize a conflict of interest or, having recognized one, fails to react properly may face disciplinary sanctions, a malpractice suit, or disqualification from representing a client in pending litigation."

Valerie J. Vollmar

Disclaimer of Joint and Survivor Interests

This article is a sequel to our report in the last issue that the Chief Counsel's Office of the Internal Revenue Service had recommended that the Service acquiesce in some recent court decisions which have held that the nine month period for disclaimers by a surviving joint tenant be-

gins at the date of death of the first joint tenant rather than at the date the joint tenancy is created. One of the key elements for these decisions was a finding by the courts that the joint tenancy was severable unilaterally by either joint tenant during the joint lifetime of the tenants. Under Oregon law, joint tenancy with right of survivorship in personal property is severable (ORS 105.920), but in real property is not severable.

In 1862, the Oregon legislature abolished the estate of joint tenancy at common law (Sec. 70-205 O.C.L.A.), and the Oregon Supreme Court has held that such an interest cannot be created in this state. *Halleck v. Halleck*, 216 Or. 23, 40, 337 P.2d 330 (1959). The use of the language on a deed of "joint tenants with right of survivorship" in Oregon is now interpreted to mean a tenancy in common in the life estate with cross-contingent remainders in the fee simple. ORS 93.180.

The court recognized that: "One of the incidents of the estate of joint tenancy is the power of either co-tenant to sever the joint estate, *i.e.*, the power to convert the joint tenancy into a tenancy in common by either joint tenant conveying his interest to a third person." *Id.* The court noted, however, that the contingent remainder interest of one co-tenant cannot not be defeated by an act of the other co-tenant. *Id.* at 41. Thus, a life estate with cross-contingent remainders is not severable by one of the co-tenants in Oregon. Because joint tenancy in real property cannot exist in Oregon and life estates with cross-contingent remainders are not severable, the Service's acquiescence based on the right of one joint tenant to sever should not be relied upon as a basis for making a qualified disclaimer by a surviving joint tenant in Oregon real property.

Helen Rives-Hendricks

OSB Annual Meeting Passes Resolutions to Amend Code of Professional Responsibility

At the Business Session of Oregon State Bar's Annual Meeting, various resolutions affecting the Code of Professional Responsibility were passed. To become effective, however, the resolutions must be adopted by the Oregon Supreme Court. This article will review the resolutions which were passed at the 1990 Annual Meeting. Once the res-

olutions are adopted, however, practitioners should review the specific text.

DR 1-103 Disclosure of Information To Authorities; Duty to Cooperate. Technical changes were made to paragraphs (D) and (E) of DR 1-103. The report required under (D) must be given to the OSB's disciplinary counsel rather than its general counsel. Paragraph (E) has been amended to delete reference to the Lawyer Alcoholism and Drug Dependencies Committee which was merged into the State Lawyers Assistance Committee.

DR 2-101 Publicity and Advertising. The restrictions in DR 2-101(D), applicable to "direct mail advertisements", have been eliminated and in their place new paragraphs (D) and (E) have been added. New paragraph (D) provides that an advertisement must be identified as such unless that fact is apparent from the context. New paragraph (E) requires that any written communication to a prospective client known to be in need of legal services in a personal injury or wrongful death matter must be identified by the word "advertisement" printed in red ink, in at least 72-point bold type, diagonally on the front and back of a legal size envelope, and on each page of the enclosed material. One purpose of this resolution was to clearly establish that, in most cases, firm newsletters are not considered to be advertisements.

DR 2-103 Recommendation of Professional Employment. New subparagraph (C)(4) was added to deal with lawyers providing legal services through nonlawyer groups. Under this new provision a lawyer can participate in the activities of such a nonlawyer group only to the extent provided in ORS 9.500 to 9.520 and the OSB disciplinary rules.

DR 5-101 Conflict of Interest: Lawyer's Self-Interest. Paragraph (A) was amended to provide that a lawyer may not *continue* employment if the lawyer's own financial business, property, or personal interest may affect the lawyer's professional judgment on behalf of his or her client. The rule previously provided only that such employment could not be *accepted* under those conditions.

DR 5-105 Conflict of Interest: Former and Current Clients.

A. Subparagraph (A)(3) was added with the intent of significantly limiting the situations in which an "issues" conflict can arise. Under this new provision, an "issues" conflict will not exist where an attorney or attorneys of the same firm are representing clients in factually unrelated cases unless one of

the attorneys actually knows that inconsistent positions are being asserted on behalf of the clients and also actually knows that a favorable outcome in one case will adversely affect the client in the other case. Even if this situation exists, representation may continue if both clients consent after full disclosure.

B. Paragraphs (E) and (F) were amended to clarify that multiple representation is prohibited only if such representation would result in an actual or likely conflict of interest. Those provisions previously prohibited such representation if the clients' interests would be in actual or likely conflict.

DR 7-102 Representing a Client Within the Bounds of the Law.

Paragraph (A) was amended to provide that its prohibitions apply not only in the case of a lawyer representing a client but also when the lawyer represents his or her own interest.

DR 7-105 Threatening Criminal Prosecution. Paragraph (A) was amended to permit a lawyer to threaten to present criminal charges in a civil matter if the lawyer reasonably believes the charges are true and if the purpose is to compel or induce the person threatened to correct the matter which is the subject of the charge.

DR 9-101 Preserving Identity of Funds and Property of a Client.

Paragraph (A) was amended to extend its coverage to funds held in escrow and other funds held by a lawyer or law firm in the course of working as lawyers. Additionally, trust accounts must be specifically designated as "Lawyer Trust Account" or "Client Trust Account".

DR 9-102 Maintenance of Trust Funds in Approved Financial Institutions; Overdraft Notification.

A. This new rule was primarily added to require that lawyer trust accounts can only be maintained in financial institutions approved by the Oregon State Bar. A financial institution will only be so approved if it agrees to provide the OSB Disciplinary Counsel with written notification of every case in which a properly payable instrument is presented against a lawyer's trust account which contains insufficient funds, even if the instrument is honored.

Implementation of this rule will require the legislature to pass appropriate legislation. If the rule is adopted by the Supreme Court, the OSB Board of Governors will introduce such legislation during the 1991 session.

B. The rule also requires that records of all transactions involving client property must be maintained for at

least five years.

As initially noted, resolutions making the above changes to the OSB Code of Professional Responsibility were passed at the 1990 Annual Meeting. The changes will not become effective, however, until they are adopted by the Oregon Supreme Court. Until the effective date contained in such adoption order, the existing Code provisions remain in effect.

Daniel C. Re

Highlights of Revenue Reconciliation Act of 1990

Following are highlights of the Revenue Reconciliation Act of 1990, Title XI of the Omnibus Budget Reconciliation Act of 1990 as passed by the House and Senate on 10/27/90, that impact estate planning and administration practices:

Tax Rates. The income tax rates for estates and trusts for tax years beginning after December 31, 1990 are as follows: 15% of the first \$3,300 taxable income, 28% of the next \$6,600 taxable income, and 31% of all taxable income exceeding \$9,900.

Foreign Grantor Trusts. Subsection (f) is added to section 672 of the Internal Revenue Code of 1986, affecting foreign persons who would otherwise be treated as the owner of any portion of a trust under Subchapter J. If a trust beneficiary is a "United States person", the beneficiary is treated as the grantor of such portion of the trust to the extent the beneficiary has transferred property directly or indirectly to the foreign person. To the extent the transferred property would be excluded from taxable gifts under Section 2503(b), it will not be considered transferred property.

Donations of Appreciated Personal Property. For a taxable year beginning in 1991, tangible personal property that appreciated in value before being donated to a charitable institution will not be a tax preference item.

Estate Freezes. Section 2036(c) has been retroactively repealed as of its effective date, and replaced with a new Chapter 14. Like 2036(c), new Sections 2701 through 2704 provide rules for valuing various "retained" and "transferred" interest in recapitalizations and other arrangements designed to freeze the value of interests held by senior family members while transferring growth to junior family members. The rules are designed to prevent perceived abuses in valuing, for gift tax purposes, transfer of certain interests in property

to junior family members. Section 2701 provides rules for determining whether a gift has been made to a junior family member, and for determining the amount of the gift when common stock or a similar partnership interest is transferred either directly or indirectly. Section 2702 provides rules for valuing interests in trusts, joint purchases and similar transactions. Generally, the value of a gift in trust is the value of the trust property reduced by the value of the interest retained by the transferor. A retained income interest is given a value of zero unless it consists of the right to receive periodically either a fixed amount or a fixed percentage of the trust property. Section 2703 provides, in general, that property is to be valued without regard to options or agreements to purchase property for less than fair market value, and without regard to restrictions on the right to sell property. Section 2704 provides that the lapse of a voting or liquidation right is to be treated as a taxable transfer.

Environmental Considerations in Estate Planning and Administration

The major environmental legislation of the last two decades turned traditional notions of liability upside down. In the last five years, courts have increasingly found parties liable who thought they were protected from such liability, either by common-law notions of responsibility and function or by their form of operation. For example, courts found that lenders may be liable for the cost of cleaning up foreclosed property. *United States v. Maryland Bank & Trust Company*, 632 F. Supp. 573 (D. Md. 1986). More recently, a lender has been held liable as the operator of a site, even without foreclosing on the borrower. *U.S. v. Mirabile*, 15 ELR 20992 (E.D.Pa. 1985). This year, the 11th Circuit found that lenders could be liable for cleanup costs simply by participating in the borrower's management of its business to the extent that the lender could control handling of environmental hazards. *U.S. v. Fleet Factors Corp.*, 31 ERC 1465 (11th Cir. 1990).

The EPA and the courts have been increasingly willing to look to parent and successor corporations as parties responsible to undertake the clean up of sites operated by the subsidiary or predecessor companies. Individuals have been found civilly and even criminally

liable for environmental misconduct based on the notion that the individual was in a position to control such conduct, even if the individual did not actually know about the activity or its illegality. Recently, various speakers, articles, and lawsuits have banded about the idea that fiduciaries may be personally liable for costs of cleaning up hazardous substances found at properties in their charge.

The question of whether a fiduciary can be held liable for the clean up of contamination on property within an estate or within the fiduciary's charge has been the subject of suit, settlement, and speculation. It remains unanswered. However, given the pattern of liability found by courts and the grave effect of such liability, it is not a question that can be ignored by fiduciaries or estate planners until it is resolved.

Just as it is now normal practice to assess environmental liability and allocate environmental risks during commercial real estate transactions, it is likely to become commonplace for estate and probate attorneys to flag the same potential for liability as a routine part of the estate planning and administration process. If courts continue to widen the net of liable parties under the environmental laws, attorneys may find that environmental considerations are as crucial as tax planning in estates involving commercial properties.

This article will discuss liability under the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA" or "Superfund") and some of the precautions that fiduciaries and estate planners might choose to take, given the potential for liability and the effect on asset value that this and similar laws might have.

Liability Under the Environmental Laws

While the field of environmental law includes many broad statutory schemes, CERCLA, found at 42 U.S.C. § 9601, *et seq.*, is the law that most threatens the unwitting landowner. CERCLA was designed to establish a cleanup program and funding mechanism for abandoned hazardous waste sites. Hence, the moniker "Superfund".

CERCLA imposes strict liability for the cost of investigation and clean up of property upon which a hazardous substance has been released. Liability is distributed jointly and severally among the following parties known as potentially responsible parties or PRPs:

- Current owners and operators of contaminated property;
- Owners and operators of the prop-

erty at the time the hazardous substances were released;

- Persons who arranged for the transport, treatment, or disposal of hazardous substances they own or possess; and
- Transporters of such hazardous substances.

Oregon's Superfund, ORS 465.200 *et seq.*, draws a slightly less inclusive net of liability.

Possible claimants under CERCLA and state counterparts include the state or federal government, injured third parties, the other potentially responsible parties enumerated above, beneficiaries of a trust, and devisees or heirs of an estate.

A hazardous substance is any substance listed pursuant to CERCLA (list found at 40 CFR 302) and substances designated pursuant to any one of the major federal environmental statutory schemes. It excludes petroleum products. However many releases of petroleum products from underground storage tanks will be affected by the Resource Conservation and Recovery Act ("RCRA") and related state laws that may also result in government imposed cleanups. The Toxic Substances Control Act ("TSCA") addresses cleanup of spills involving PCB's (polychlorinated biphenyls).

CERCLA imposes liability retroactively, even for activity that was legal and prudent at the time it was undertaken. It was written to draw liability as broadly as possible. The courts and the enforcement posture of the EPA have continued to make liability more and more inclusive. If this trend continues it may reach out to include such deep-pocket respondents as financial institutions and trust departments.

Liability as an Owner or Operator

If the EPA or the state can successfully argue that a fiduciary is either the owner or operator of a site, that fiduciary is very likely to assume liability for the environmental problems attendant to that site.

"Owner" is a particularly troubling term for trustees, who have traditionally been considered in the chain of title for the assets within the trust. But the personal representative is no less at risk of being dragged into the ever-widening application of "operator".

The most recent expansion of the term operator came in the *Fleet Factors* case, cited above. In that case, a lender hired agents to prepare assets for auction. When the agents caused a release of hazardous substances, the lender was

held liable under CERCLA as an operator. The court cited, as its rationale, the overwhelming remedial goal of CERCLA, which should cause ambiguous terms to be construed in favor of finding liability and also, the lender's ability to protect itself by investigating property before making loans. This same reasoning might well persuade a court that a fiduciary has an opportunity to discover that property is contaminated and can therefore protect itself from troubled property.

Similarly disconcerting are the decisions from courts that have been willing to pierce the corporate veil and find parent corporations or shareholders liable for cleanup costs of the subsidiary or the partially-owned corporation. See *Joslyn Corporation v. T.L. James & Co.*, 696 F. Supp. 222 (W.D. La. 1988). Will courts be anxious to pierce the "trust veil" to find fiduciaries liable?

Even if courts are hesitant to disregard the corporate form, there are cautionary flags from those courts that have found it unnecessary to wrestle with the corporate veil, but instead, are anxious to find that the parent corporation or shareholder controlled the management of a site. "A stockholder, parent corporation, or any person associated with a facility, whether he has any ownership interest or not, may be held liable if that person (including a corporate entity) controls the management and operation of the polluting corporation. This approach focuses primarily on control. *U.S. v. Kayser Roth Corp.*, No 99-0325B (D.C. R.I. October 11, 1989).

The usual duties and obligations of fiduciaries suddenly look quite perilous, while the deep pockets of many traditional fiduciaries seem quite inviting to the governments and other responsible parties looking to fund costly cleanups. There are some approaches attorneys might want to try while they tread in these untested waters.

Defenses to Liability

CERCLA does make some exceptions from liability, but these exceptions are narrowly drawn and even more narrowly construed. The innocent landowner defense would allow a current landowner to avoid liability if he can show that the contamination was due solely to actions of a third party. This defense is unavailable if there is contractual privity between the innocent landowner and the third party at fault.

Where there is such a contractual relationship, the owner who wishes to assert the innocent landowner defense

must show that he

- acquired the property after the disposal of hazardous substances;
- did not know, and had no reason to know, that hazardous substances were disposed of on the property; and
- undertook all appropriate inquiries into the previous ownership and uses of the property, consistent with good commercial or customary practice (a "due diligence" inquiry).

Courts evaluating this last factor will take into account the sophistication and expertise of the owner as well as the obvious presence or likelihood of contamination.

Both federal and Oregon law will consider the owner who acquires a property by inheritance or bequest an innocent purchaser. However, this obviously does not apply to the fiduciary of a trust or estate. Furthermore, while this defense may cut off CERCLA liability, the owner who takes by inheritance or bequest may still be saddled with a property that is greatly depreciated in value or, worse yet, a drain on other assets.

CERCLA Liability and the Estate Planning Process

Attorneys creating an estate plan should be mindful that the presence of CERCLA liability can deplete all of the assets in the estate and possibly expose beneficiaries and fiduciaries to personal liability for cleanup costs which could exceed the estate's resources. Addressing the risk of liability at the estate planning stage will accomplish several things. First, it enables the grantor to accurately value the various estate assets. Identifying problem properties at the outset ensures that the grantor's intentions are carried out. For example, a piece of commercial property thought to be valuable might prove to be a tremendous liability. If a particular testamentary instrument passes separate pieces of property to separate beneficiaries, the beneficiary acquiring the piece of contaminated property would be unfairly treated against the grantor's wishes. Moreover, tax consequences can be better anticipated with an accurate estate valuation. Finally, discovery of contaminated land at the estate planning stage allows some flexibility in dealing with the problem and limiting the liability of all parties concerned. After the estate passes, the options for the beneficiaries and fiduciaries are greatly narrowed, and the risk of being locked into liability increases.

An important task for the estate plan-

ning attorney, then, is to spot potential problem assets. As part of the initial client interview, the attorney should explore the nature of any properties held individually by the grantor or by a corporation or other entity in which the grantor is an owner or active participant. The inquiry should focus not only on properties presently owned or operated by the grantor, but also on properties previously owned or operated, as CERCLA liability extends to both past and present owners and operators. If the initial questioning reveals any commercial, industrial, or agricultural properties, the attorney should conduct an environmental survey to explore the possibility of contamination. Such a survey normally addresses, among other things, the present and historical use of the property, the storage or use of chemicals on the property, the presence of drums, barrels or tanks on the property, and the nature of surrounding properties.

If the survey reveals the possibility of any contamination on the property, or the possibility of contamination migrating onto the property from surrounding properties, it may be advisable to commission a Phase I assessment by a reputable environmental consulting firm. Such Phase I assessments are not yet performed routinely as part of the estate planning process, but are performed routinely during real estate transactions involving commercial properties. This level of assessment typically consists of a field inspection of the property, a records search in government files, examination of aerial maps, and interviews with current owners or operators of the property. A Phase I assessment normally does not include intrusive measures such as sampling and analysis. Phase I assessment costs vary considerably based on the complexity of the site, but generally range from \$1,000 to \$10,000.

Phase I assessments are not necessarily conclusive. However, they may, in some circumstances, satisfy the "due diligence" requirement that purchasers of property must demonstrate before qualifying for an "innocent-landowner" or "third-party" defense. Since it appears that fiduciaries and beneficiaries may also have to make appropriate inquiries to take advantage of those defenses, a Phase I assessment during the estate planning stage which results in no suspicious findings might make available these defenses to beneficiaries and fiduciaries, should contamination be discovered once the estate passes.

If the Phase I assessment reveals a

risk of contamination, the client arrives at a decision-making crossroad. The client may choose to discover the full extent of contamination and deal with the problem at this stage. This choice is costly and normally entails a Phase II investigation, which can involve extensive sampling and analysis. The cost of this phase of investigation often greatly exceeds \$10,000. If this is the client's choice and contamination is discovered, the client is then faced with the decision of whether to finance remediation of the site and sue other responsible parties (if any) for contribution, sell the site (which could be difficult if the cost of cleanup exceeds the assessed value of the site), or keep the site. Further, the discovery of contamination may, in some circumstances, trigger a duty to report and clean up the contamination under the applicable federal and state laws.

If the Phase I assessment has ambiguous results, the client may choose not to proceed with a Phase II assessment. It may not be feasible for the client to engage in a full-blown environmental investigation and remediation. In that case, the risk associated with the property should be dealt with as part of the estate planning process. Assuming the client wishes to retain the property, proper procedures should be taken to minimize the risk of liability to both the fiduciary and beneficiary. Several options have been offered in the literature on this subject, but none have been tested for certainty.

First, the attorney might separate the problem property from the other assets in the estate by creating a separate trust. This might reduce the likelihood that liability stemming from the problem property (assuming it exceeds the commercial value of the asset) will swallow up the value of the remaining assets. Attorneys should be aware that the analogous course of creating a separate corporate shell has not always worked to protect successor or parent corporations from liability under CERCLA. Moreover, the problem of locating a trustee may constitute a practical barrier.

Whether the problem property remains in the estate or shifts to a separate trust, other measures should be explored to reduce the risk of personal liability to the fiduciary and beneficiaries. Insurance policies issued on the problem property should be examined for possible coverage, although policies issued in recent years normally contain a tight pollution exclusion clause. The will or trust agreement might be drafted to provide the fiduciary with the option

of resignation, and the beneficiaries a designated time period within which to disclaim their rights to the problem asset.

The will or trust agreement might expressly relieve the fiduciary of liability to the beneficiaries resulting from the fiduciary's compliance with environmental laws, including reporting obligations. Another possibility is that the instrument might authorize the fiduciary to address environmental concerns by monitoring, reviewing and inspecting the problem property, and using trust assets to clean up the property in an expeditious fashion. At the same time, the instrument might provide the fiduciary with the option to forego responsibilities which could be construed as day-to-day activities relating to the operation of the property or asset—activities which could trigger liability as an operator.

While all of these measures have been offered in the literature on the subject, attorneys should bear in mind that the appropriateness and effectiveness of any one of them depends upon a wide variety of factors relating to the problem asset and the overall estate, and the best judgment as to the value of each measure is likely to result from collaboration of environmental attorneys and trust and estate attorneys.

Addressing CERCLA Liability in Estate Administration

There is certainly no established protocol for dealing with the administration of an estate containing contaminated real property. Chances are good that the potential for CERCLA liability was not anticipated at the estate planning stage. Fiduciaries of this type of estate are faced with a variety of difficult choices as well as conflicting duties and interests.

It is important to recognize at the outset a potential conflict of interest facing the fiduciary. The fiduciary might be exposed to the risk of CERCLA liability not only by virtue of its legal title as "owner" of the asset, but also by its role as manager of the estate or trust, which places it in jeopardy of being classified as an "operator" as well under CERCLA. As a potentially liable party, the fiduciary may find it in its best interest to conduct a preliminary environmental assessment of any suspect property and undertake other inquiries to avail itself of the "third-party" or "innocent-landowner" defense if contamination is discovered. Moreover, the fiduciary may be required to comply with certain reporting requirements under CERCLA and other

environmental laws. Yet, discovery of environmental problems may result in severe devaluation of the property and may also expose the beneficiaries to personal liability for cleanup costs, if such costs exceed the estate's overall value. In short, steps taken by the fiduciary to insulate itself from CERCLA liability may breach the duty of loyalty owed to the beneficiaries. On the other hand, the duty of disclosure owed to the beneficiaries may necessitate an environmental assessment of suspect properties.

It is advisable for the fiduciary of any estate containing commercial properties to at least take the first step of identifying potential problem assets using the "survey" approach discussed earlier. With the resulting knowledge, the fiduciary would be prepared to make an informed decision concerning whether to commission an environmental assessment of any suspect properties. Several considerations weigh into the decision of whether to take this next step of environmental investigation. As a general matter, the less the fiduciary is involved with the operation or management of a problem site, and the shorter the time period of any involvement, the more likely the fiduciary will be able to avail itself of a defense to CERCLA liability. There is often a fine line between exercising due diligence with respect to a site and crossing that threshold of involvement to where the fiduciary assumes operator status.

The choice of whether to commission an environmental assessment might also, in part, be dictated by tax concerns. If, in filing tax returns for the estate or trust, the fiduciary fails to account for the devaluation of a certain piece of property due to contamination, the fiduciary might overvalue the estate and be liable to the beneficiaries for unnecessary taxes paid.

Finally, in the case of a personal representative, the decision of whether to commission an environmental assessment might be dictated by the fiduciary's duties pursuant to ORS 115.001 *et seq.* Under this statute, personal representatives are required to "make reasonably diligent efforts to investigate the financial records and affairs of the decedent and shall take such further actions as may be reasonably necessary" to identify and notify persons with potential claims against the estate. Because the statute does not limit its applicability to certain types of claims, the statutory duty might be triggered with respect to potential CERCLA claims. Where, for example, a decedent owned a piece of property

on which hazardous substances were released during the period of ownership, and then sold the property to a third party who is potentially liable under CERCLA, that third party might have a claim against the decedent's estate for contribution of cleanup costs. Under the language of ORS 115.001, it is possible that the fiduciary has a duty to search for such potential environmental claimants. It should be noted, however, that ORS 115.003(2) does not require the fiduciary to give notice of "merely conjectural" claims. How that standard could operate in the context of CERCLA claims is not clear. However, it is safe to assume that an environmental assessment which reveals extensive contamination might well transform an otherwise "merely conjectural" claim into one for which notification is arguably required pursuant to ORS 115.003.

Conclusion

Unfortunately this article raises many important questions and provides few answers. Simply deciding whether or not to go forward with an environmental assessment presents the fiduciary with a number of difficult and, perhaps, conflicting choices and duties. Choices become more complicated if an environmental assessment shows that property is contaminated. Liability based on conjecture and apprehension compounded by untested procedures to avoid such liability give small comfort to the conscientious practitioner.

There are several pieces of legislation before Congress that would, in part, limit the environmental liabilities of fiduciaries. However, those bills, even if passed, will not allow practitioners in this field to return to the "Eden" of environmental ignorance. A certain level of awareness and inquiry will be required under any regulatory scheme, and is demanded today by good practice. Practitioners in the estate planning and probate field will want to address environmental concerns both in estate planning and estate administration, routinely. They will want to work with environmental lawyers to follow developments in environmental law so they adapt to the rapid changes in this field.

Miriam Feder
Mary Christina Wood

Calendar of Seminars and Events

The following is a selective schedule of seminars which may be of particular interest to Section Members:

- January 7-11, 1991 (Sponsored by University of Miami, Law Center) **25th Annual Institute on Estate Planning**, Fontainebleau Hilton Resort & Spa, Miami Beach, Florida. Telephone: (305) 284-4762.
- January 21-24, 1991 (Sponsored by the University of Southern California, Law Center) **Tax Conference**, University of Southern California, University Park, Los Angeles, California. Telephone: (213) 740-2582.
- January 26, 1991 (Sponsored by Northwestern School of Law and Estate Planning Council of Portland) **20th Annual Estate Planning Seminar**, Jantzen Beach Red Lion, Portland, Oregon. Telephone: (503) 244-1181.
- February 2-9, 1991 (Sponsored by National Law Foundation) **Barbados Estate, Tax and Financial Planning Conference**, Heywoods Resort, Barbados. Telephone: (301) 656-4757.
- February 7-8, 1991 (Sponsored by Practicing Law Institute) **Estate and Financial Planning for Aging and Incapacitated Clients**, PLI Training Center, New York, New York. Telephone: (212) 765-5700.
- February 13-15, 1991 (Sponsored by ALI-ABA and Utah State Bar) **Basic Estate and Gift Taxation and Planning**, Olympia Hotel, Park City, Utah. Telephone: (800) CLE-NEWS.
- March, 1991 (Date not set) (Sponsored by Southern California Tax & Estate Planning Forum) **Estate Planning for Business**, San Francisco, California (Friday). Telephone: (619) 298-7620.
- March, 1991 (Date not set) (Sponsored by Southern California Tax & Estate Planning Forum) **Estate Planning for Business**, Los Angeles, California (Saturday). Telephone: (619) 298-7620.
- April 29, 1991 (Sponsored by Southern California Tax & Estate Planning Forum) **Marital Deduction Planning**, San Francisco, California (Friday). Telephone: (619) 298-7620.
- April 30, 1991 (Sponsored by Southern California Tax & Estate Planning Forum) **Marital Deduction Planning**, Los Angeles, California (Saturday). Telephone: (619) 298-7620.
- October 9-12, 1991 (Sponsored by Southern California Tax & Estate Planning Forum) **11th Annual Southern California Tax & Estate Planning Forum**, Meridien Hotel, San Diego, California. Telephone: (619) 298-7620.



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Restrictions on Intra-Family Business Transfers Thawed Under New Estate Freeze Rules

The Omnibus Budget Reconciliation Act of 1990 retroactively repealed I.R.C. §2036(c), replacing it with new §§2701 through 2704. As did §2036(c), the new sections apply primarily to the transfer of business interests from parents to their children. Section 2036(c) worked to bring back into the estate of the transferring parent the growth of the interest after the transfer, but did not create tax consequences on the initial transfer. The new sections, on the other hand, apply primarily to the valuation of the transferred interests at the time of the original transfer, and will allow, with some constraints, the appreciation of the transferred interests to escape taxation in the parents' estate. As a consequence, estate "freeze" techniques are once again a viable planning option for business interests with high growth potential.

§2701: Transfers of Stock and Partnership Interests

The purpose of new §2701 is to prevent what the Service perceived to be abuses by taxpayers in valuing gifts of common stock (or similar partnership interests) in an estate freeze. In the typical estate freeze, a parent conveys common stock to his children, while retaining preferred stock. Because the rights of the preferred stock are fixed as to income and liquidating distributions, its value

remains "frozen." The common stockholders are entitled to the residual income and appreciation, which although initially low, can increase substantially over the years.

Both the abuses and the rules enacted to combat them rely on "present law principles that value residual interests by subtracting the value of preferred interests from the value of the entire corporation or partnership, with an adjustment [*i.e.* minority discount] to reflect the actual fragmented ownership." Conf. Rep. at 1132. (A complete discussion of these principles is outside the scope of this article, but the following ruling and cases may be helpful in understanding how they have been applied: Rev. Rul. 83-120; *Estate of Newhouse*, 94 T.C. 193 (1990), and *Estate of James W. Anderson*, T.C. Memo 88-511; and *Roy O. Martin Jr.*, T.C. Memo 1985-424.) Frozen interests are therefore structured to absorb as much of the current value of the company as possible, so as to lower, for gift tax purposes, the value of the common stock. For example, the preferred stockholders usually retain redemption or liquidation rights equal to, or even exceeding, the current value of the business' assets, or retain conversion rights which allow them to convert their stock to common stock of an equal value, and thereafter share in the future appreciation of the business. These rights have usually been given significant value, even though they will very likely never be exercised. The gift tax value of the common stock given to the children is correspondingly lower, sometimes reducing the value of the common stock to a nominal amount.

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For a recent example, see *Elizabeth W. Snyder*, 93 T.C. 529 (1989).

Through §2701, Congress sought to eliminate the most egregious of these abuses. In general, the section is designed simply to do two things: (1) Provide rules for valuing certain specific rights retained by the spouse and ancestors of the common interest holders, and (2) provide rules for determining the transfer tax treatment of a failure to pay cumulative distributions.

Three Valuation Rules of §2701.

For purposes of determining the value of common stock or a partnership interest transferred to a transferor's spouse, lineal descendants and their spouses, three valuation rules apply:

1. Section 2701(a)(3)(A):

Noncumulative distribution rights and liquidation, put, call or conversion rights retained by the transferor, his spouse, their ancestors and their spouses must be given a value of zero.

2. Section 2701(a)(3)(B): If the retained interest consists of cumulative distribution rights and liquidation, put, call or conversion rights, the interest is valued by assuming the latter rights were exercised in a manner resulting in the lowest value for all the rights. §2701(a)(3)(B).

Example 1. P transfers all of Corporation X's common stock to C, retaining all of the preferred stock (par value \$1,000). The preferred stock carries a dividend right of 10% of par value, or \$100 per year, and a redemption right of \$900, exercisable at any time after two years. The value of the preferred stock is the lesser of (1) the present value of \$100 payable every year in perpetuity, or (2) the present value of two years of dividends of \$100 plus the present value of the redemption for \$900 after two years. The statute does not specify the rate applicable in discounting the liquidation right. A staff member of the Senate Finance Committee has indicated that the rate should be equal to the dividend rate payable on the preferred stock, in this example, 10%. The present

value of the right to receive \$100/year in perpetuity is \$1000 (\$100/0.1). The present value of two years of dividends discounted at a 10% annual rate is \$174, and the present value of \$900 after two years is \$743, for a total value of \$917. The value of the preferred stock would therefore be \$917 — the lower of the two amounts.

The purpose of this rule is to prevent the transferor from inflating the value of his preferred stock (and reducing the value of his gift of common stock) by retaining an unrealistically high distribution right, and subsequently liquidating or redeeming his stock at a lower price, effectively freezing his interest at a value lower than that used to value the common stock.

3. Section 2701(a)(4): The aggregate value of the common stock (or similar partnership interest) can be no less than 10 percent of the sum of the total equity in the corporation or partnership plus any debt which the corporation or partnership owes to the transferor or member of his family. §2701(a)(4). Minority discounts are still applicable in valuing the transferred common interests, but apparently cannot reduce the value of the common interest to an amount less than the 10% floor.

For purposes of applying the three valuation rules, an individual is treated as owning any interest to the extent the interest is held indirectly through a corporation, partnership or trust. §2701(e)(3).

The holder of a retained interest may elect to treat noncumulative distribution rights as cumulative, or cumulative rights as noncumulative. §2701(c)(3)(C). The statute imposes tax consequences on the nonpayment of cumulative dividends, discussed below. A retained interest holder would not want to make an election either way without assessing these consequences.

Contributions to capital, redemptions, recapitalizations and similar restructurings are treated as a transfer if the effect is the same as a transfer. This rule does not apply if the interests held both before and after the change are substantially identical. The

Service is given regulatory authority in this area. §2701(e)(5).

Exceptions to the General Rules.

Numerous exceptions to the general rules exist. Some are classified as such; some operate as such:

Lack of Control. If the transferor, the transferor's spouse, their ancestors and their ancestors' spouses do not control the business immediately before the transfer, §2701 does not apply. They do not control the business if they own less than 50% of the interests in the business (whether stock or partnership interests), and, if the business is a limited partnership, are not general partners of the partnership. For purposes of determining control, each individual is treated as owning the interest held by his or her siblings and lineal descendants, and any interest held indirectly through a corporation, partnership or trust. §2701(b)(1).

Market Quotations. The statute does not apply to any interest for which market quotations are available. §2701(a)(2).

Same Class. The statute does not apply to retained interests of the same class or proportionally the same (other than voting power) as the transferred interest. §2701(a)(2).

Mandatory "Rights". The statute does not apply to liquidation, put, call or conversion rights which must be exercised at a specific time at a specific amount. §2701(c)(2)(B).

Voting Rights. The section does not by its terms apply to voting rights. §2701(a)(3)(A). Thus, noncumulative preferred voting stock may be given some value if the holder has voting control.

Fixed Conversion Rights. The statute does not apply to a nonlapsing right to convert the retained stock or partnership interest into a fixed number or percentage of shares of the same class as the transferred stock. §2701(c)(2)(C). However, it does apply to a right to convert preferred shares to common having a value equal to the preferred.

Guaranteed Payments. The statute does not apply to guaranteed payments of a fixed amount to a partner under §707(c). §2701(c)(1)(B)(iii).

Treatment of Unpaid Cumulative Distributions.

The general effect of the valuation rules is to limit the valuation of preferred interests to a consideration of cumulative dividends payable on such interests. The rules allow the preferred interest to be valued in accordance with the dividend rate chosen by the shareholders. Thus, a preferred stockholder may still minimize (subject to the 10% floor) the gift tax value of the common stock by retaining a high preferred dividend rate. However, Congress has given the preferred interest holder an incentive to keep his dividend rate at a realistic level by including a provision which effectively treats as a taxable gift to the common stockholders the nonpayment of dividends on cumulative stock.

The statute provides that upon the retained interest holder's death or upon the lifetime transfer or termination of the retained interest, the value of the retained interest is increased for estate or gift tax purposes to take into account the increase in value conferred on the common stock. §2701(d). This rule applies only to distributions payable on stock which was not valued at zero under §2701(a)(3)(A). The increase in value is equal to the excess of —

(a) the value of all payments from the date of the original transfer to the date of the current transfer, determined as if paid when due and reinvested at a yield equal to the discount rate used to value the original transfer, *over*

(b) the value of the payments actually made during the period, determined as if reinvested at the same discount rate. §2701(d)(2)(A).

Any payment made within 4 years of its due date is treated as having been made on the due date. §2701(d)(2)(C).

The increase is limited to the actual increase in value of all interests, whether or not held by family members, junior to the retained preferred interest, from the date of the original transfer to the date of the subsequent transfer, multiplied by the percentage of the preferred interest held by the transferor on the date of the subsequent transfer. §2701(d)(2)(B).

Example 2. On December 31, 1990, P transfers all of

Corporation X's common stock to C, retaining all of the preferred stock. The preferred stock carries a dividend right of \$100 per year, payable at the end of each year. P receives \$100 on December 31, 1991, but does not receive dividends in either 1992 or 1993. P dies on January 1, 1994. The date-of-death value of the 1991, 1992 and 1993 payments, determined as if paid when due, and reinvested at a 10% rate (from

Example 1), would be \$121, \$110 and \$100, respectively, for a total of \$331. The date-of-death value of the payments actually made is \$121, the only actual payment being the 1991 payment. The difference of \$210 (\$331 - \$121) is the amount by which the value of P's stock must be increased for estate tax purposes, subject to the growth limitation. If the value of the common stock held by C had grown only \$100 from the date of the transfer to C until P's death, the increase in value of P's stock is limited to \$100.

If the interest is transferred to the transferor's spouse in a transfer qualifying for the marital deduction, or does not result in a gift by reason of consideration given by the spouse, the increase is not currently taxed, but the transferee spouse is treated the same as the transferor for purposes of subsequent transfers. §2701(d)(4)(A).

In the case of a lifetime transfer to the transferor's ancestors, the ancestors are treated in the same manner as the transferor as to distributions accumulating on the transferred interest after the transfer. §2701(d)(4)(B).

Section 2701(d) literally applies only to distributions payable on cumulative stock (or a partnership interest) which was valued under §2701(a)(3)(B). If the holder of the preferred stock did not retain liquidation, put, call or conversion rights, §2701(a)(3)(B) would not by its terms apply, and consequently §2701(d) would also not apply, completely removing such preferred stock from the application of §2701. This result was not intended by the drafters of §2701. It is anticipated that §2701 will be amended by technical

corrections to bring within its scope all distributions payable on cumulative stock.

Under regulations prescribed by the Secretary, "appropriate adjustments" will be made for estate, gift and generation skipping tax purposes to reflect the increase in the amount of any prior taxable gift of common stock or similar partnership interests by reason of valuation under §2701. Regulations may also be issued which treat a retained interest as two or more interests.

§2702: Transfers Into Trust Retained Right must be Annuity or Unitrust.

When property is transferred in trust for the benefit of the transferor's family, any interest retained by the grantor or his or her ancestors is valued at zero unless it is a "qualified interest". A "qualified interest" is defined as:

(a) an annuity in a fixed amount (Grantor Retained Annuity Trust, or "GRAT");

(b) an annuity measured by a fixed percentage of the value of the trust assets (Grantor Retained Unitrust, or "GRUT"); or

(c) any noncontingent remainder interest if all the other interests in the trust consist of interests described in (a) or (b) above.

A retained interest in all the trust income for a specified period (a GRIT), is not a qualified interest and is valued at zero. The amount transferred is equal to the full value of the property.

Joint Interests.

The transfer of an interest in property of which family members hold successive term or remainder interests is treated as a transfer into trust. Any term interest retained by the transferor will not be a qualified interest and will be valued at zero.

In the case of a joint purchase, the transferor will be treated as having acquired the entire property and transferred the remainder interest to the family member for the consideration provided by the family member.

Exceptions.

(a) **Personal Residence.** The section does not apply to a transfer to a trust which holds solely a

residence to be used as a personal residence of the grantor.

(b) **Incomplete Transfer.** The section does not apply to the extent the transfer is incomplete for gift tax purposes.

(c) **Valuation Rule for Certain Term Interests.** If the nonexercise of rights under a term interest in tangible property would not have a substantial effect on the valuation of the remainder interest (such as bare land or art), the value of the term interest is the value at which the term interest could be sold to an unrelated third-party.

§2703: Buy-Sell Agreements

A buy-sell agreement is now disregarded for valuation purposes, unless:

(a) It is a bona fide business arrangement; and

(b) It is not a device to transfer the property to members of a decedent's family for less than full and adequate consideration; and

(c) The terms are comparable to arm's length agreements.

§2704: Lapsing Rights And Restrictions

Lapsing Rights.

The lapse of a voting or liquidation right held by an individual is treated as a transfer equal to the value of all the interests in the entity held by the individual before the lapse (determined as if the right were nonlapsing) over the value of such interests held after the lapse. This provision applies only if the transferor or the transferor's family have 50% control of the entity both *before and after* the lapse.

This provision apparently applies to a liquidation right notwithstanding the fact that the right may have been valued at zero in a transfer to which §2701 applied, thereby double-counting a portion of the gift. Congress is considering technical corrections to eliminate the possibility of double-counting.

Removable Restrictions.

Any restriction that effectively limits the ability of a corporation or partnership to liquidate (e.g. prohibition against termination in partnership agreement) is ignored in

valuing a transfer among family members if the restriction either lapses after the transfer or can be removed after the transfer by the transferor or members of his family, either alone or collectively. This applies only if the transferor and the transferor's family control the entity *before* the transfer.

Effective Dates

Sections 2701 and 2702 apply to *transfers* made after October 8, 1990. However, with respect to property transferred before October 8, the failure to exercise a conversion right, to pay dividends, and to exercise other rights to be specified in regulations will not be treated as a subsequent transfer. Section 2703 applies to agreements, options, rights or restrictions entered into or granted, or are substantially modified, after October 8, 1990. Section 2704 applies to restrictions or rights (or limitations on rights) created after October 8, 1990.

Bibliography

Articles on this topic have recently appeared in all the major tax publications. A few of these include:

Mulligan, *Estate freeze rules eased by new tax law but other restrictions are imposed*, 18 Estate Planning 2 (Jan/Feb 1991).

Gardner, *Estate Freezes 1990 and Beyond: The Story of the Repeal of Section 2036(c) and the Valuation Rules That Took Its Place*, 69 Taxes 3 (Jan. 1991).

Mezzullo, *New Estate Freeze Rules Replacing 2036(c) Expand Planning Potential*, 74 Journal of Taxation 4 (Jan. 1991).

Stephen J. Klarquist

What's New

In Re Harrell 104 Or App 332 (1990)

Petitioner, a life income beneficiary of a trust, sought court approval of a proposed agreement to modify the trust. The terms of the trust provided that upon the death of the last to die of the two income beneficiaries, the remainder would be distributed outright to the petitioner's children or their lineal descendants. One of

petitioner's children was mentally retarded and would probably require care and supervision all of his life. He currently qualified for Medicaid and Social Security benefits, both of which have income and resource limitations for the participants. Outright distribution of the trust funds to the child would disqualify him from the public assistance benefits until the trust proceeds were consumed.

The petitioner sought to modify the trust to have this child's share continue in trust and only be available as a secondary source of funds to supplement rather than replace his current income and benefits from public assistance. The trial court denied the petition to modify the trust and the Court of Appeals affirmed, holding that ORS 128.135(2)(c) does not grant a court authority to modify the distribution of a trust. The court indicated that the authority which the statute gives the court is limited to approving or giving instructions concerning a distribution under the terms of the trust. Petitioner further contended that the court had authority under common law principles to modify the distribution of a trust. The court, however, found no such authority.

Judge Riggs and Judge Edmonds filed dissenting opinions stating that they believed that the language of ORS 128.135(2)(c) granted the probate court broad discretionary powers and that the modification of the distribution of a trust was within the scope of the statute.

Helen Rives-Hendricks

Oregon Supreme Court Acts on Resolutions to Amend Code of Professional Responsibility

On December 28, 1990 the Oregon Supreme Court acted upon the resolutions passed at the Business Session of the Oregon State Bar's 1990 Annual Meeting to amend the Code of Professional Responsibility. On that date the court adopted the amendments to DR 1-103, DR 2-103, DR 5-101, DR 5-105, DR 7-102 and DR 7-105.

Additionally, the court adopted a portion of the proposed amendment to DR 9-101. The approved change to the rule requires that escrow and other funds held by a lawyer or law firm for

another in the course of work as lawyers must now be deposited and maintained in trust accounts. The proposed changes to DR 9-101 and DR 9-102 set forth in Resolution Number 12 at the Annual Meeting were not approved but were referred to the Committee on Disciplinary Rules and Procedures for a recommendation.

The court did not adopt the proposed changes to DR 2-101 which would have modified the rules for direct mail advertising.

The adopted changes became effective on January 2, 1991.

Daniel C. Re

Community Property Concepts for Oregon Estates

Oregon is surrounded by three community property states, California, Idaho and Washington. Many Oregon couples have lived in one or more of these neighboring jurisdictions, or in Arizona, Louisiana, Nevada, New Mexico or Texas, the remaining U. S. community property jurisdictions. It is therefore important for Oregon practitioners, whether creating an estate plan for such a couple or administering the estate of one partner of such a couple, to understand both the importance of community property to the estate and basic community property concepts.

Importance of Community Property to Oregon Residents. Community property concepts are important to the disposition of a couple's property because Oregon has enacted the Uniform Disposition of Community Property Rights at Death Act (the "Act"). ORS 112.705 - 112.775. In addition, the surviving spouse who receives the decedent's interest in the couple's property is entitled to special benefits under the Internal Revenue Code, giving the surviving spouse a step-up in basis in his or her one-half interest in the community property, as well as the decedent's one-half interest. IRC 1014(b)(6).

Disposition of Community Property. The Act codifies the treatment of the following property

upon the death in Oregon of the first spouse to die:

"(1) All personal property, wherever situated:

"(a) Which was acquired as or became, and remained, community property under the laws of another jurisdiction; or

"(b) All or the proportionate part of that property acquired with the rents, issues, or income of, or the proceeds from, or in exchange for, that community property; or

"(c) Traceable to that community property.

"(2) All or the proportionate part of any real property situated in this state which was acquired with the rents, issues or income of, the proceeds from, or in exchange for, property acquired as or which became, and remained, community property under the laws of another jurisdiction, or property traceable to that community property." ORS 112.715

ORS 112.725 creates two rebuttable presumptions. First, property acquired during a marriage in a community property state is presumed to be community property. Second, Oregon real property and all personal property acquired during a marriage and titled with rights of survivorship while the couple resides in a non-community property state is presumed not to be community property.

The testamentary disposition of such property differs from the disposition of property that was never community property:

"Upon death (sic) of a married person, one-half of the property to which ORS 112.705 to 112.775 apply is the property of the surviving spouse and is not subject to testamentary disposition by the decedent or distribution under the laws of succession of this state." ORS 112.735.

The personal representative and the court have no duty to discover whether any property titled in the decedent's name is subject to the Act unless the surviving spouse makes a written demand. ORS 112.745. Likewise, the personal representative has no duty to discover whether any property titled in the surviving spouse's name is subject

to the Act unless an heir, devisee or creditor makes a written demand. ORS 112.755. Such written demands should be made early in the estate administration, because ORS 112.765 confers rights upon purchasers for value of property subject to the Act and lenders taking security interests in property subject to the Act.

Tax Basis of Community Property. IRC 1014(a) provides that property in the hands of a person who acquired the property from a decedent has a basis equal to the fair market value of the property at the date of the decedent's death, or if the personal representative elects to use the alternate valuation date, on the date six months after the decedent's death. IRC 1014(c) excepts from this step-up in basis, all property which constitutes a right to receive an item of income in respect of a decedent under IRC 691. IRC 1014(b)(6) further provides that the decedent's surviving spouse is entitled to a step-up in basis for his or her interest in property that is community, "under the community property laws of any state or possession of the United States or any foreign country." Thus, if a decedent's asset is community property "under the community property laws of any state," then the surviving spouse's one-half share of the community property will qualify for a step-up in basis, as well as the decedent's one-half share.

It is settled that, when a federal tax statute describes the taxpayer's property rights as a test of taxability, the existence of the property rights must be discovered under the controlling local law. *See, e.g. Blair v. Comr*, 300 US 5 (1937).

Oregon is not a community property state. No case has addressed whether property of an Oregon decedent is entitled to the IRC 1014(b)(6) step-up in basis. However, it appears that Oregon follows the general rule that personal property that was acquired in a community property state will maintain its community nature when removed to a common law state. *See* 15A Am Jur 2d Community Property § 18 (1976); Restatement (Second) of *Conflict of Laws* § 259 (1971).

While the Act treats certain property as community property, it does not

label it as such. However, the Prefatory Note to the Uniform Act states that the Act is necessary to ensure that states uniformly enact legislation to dispose of community property which has moved into a common law state, as an initial step, without addressing other aspects of the community nature of the property, such as creditors' rights, rights upon dissolution of marriage, etc. Although it could be argued that the Act determines the disposition of property and not the nature of the property as community or separate, the better view is that the Act does not remove the community status of the property but simply disposes of the property in a manner consistent with its community status.

Additionally, several cases and Attorney General Opinions indicate that Oregon recognizes that the community or separate nature of property acquired in a community property state does not change when the property enters Oregon. *See, e.g. Bosma v. Harder*, 94 Or 219, 185 P 741 (1919); Informal Attorney General Opinion, dated August 9, 1954; *Zurow v. Friendly*, 251 Or 423, 446 P2d 110 (1968); and *Keller v. Dept. of Rev.*, 292 Or 639, 642 P2d 284 (1982).

Based on the Act and these cases, it is arguable that an Oregon surviving spouse is entitled to an IRC 1014 step-up in basis for his or her one-half interest in community property.

Basic Community Property Concepts

The remainder of this article will discuss some basic concepts that exist in one form or another in many of the community property jurisdictions. When determining whether a couple's property will be entitled to the IRC 1014(b)(6) step-up in basis or will be disposed of as provided by Oregon's Act, the specific laws of the community property jurisdictions in which the couple have lived must be analyzed. The following discussion merely illustrates some of the issues that may be involved.

Community vs. Separate Nature. Generally, community property is defined as property earned by either

spouse during marriage, proceeds of such property, and income earned by such property. For example, in Washington, all property not defined as separate property is community property. RCW 26.16.030. The separate property of a husband is defined as:

"Property and pecuniary rights owned by the husband before marriage and that acquired by him afterwards by gift, bequest, devise or descent, with the rents, issues, and profits thereof ***." RCW 26.16.010.

RCW 26.16.020 describes the separate property of a wife in similar manner. Cal Civ Code 5108 and 5107 define the separate property of California husbands and wives in the same terms.

Change in Form of Property.

Generally, proceeds of property that is community in nature will remain community in nature. For example, case law in Washington has established that property acquired by purchase or exchange has the same marital character as the money or property used to acquire it. *See In re Pugh's Estate*, 18 Wash 2d 501, 139 P2d 698 (1943); *Myers v. Vayette*, 146 Wash 1, 261 P 647 (1927). Federal tax decisions have also recognized that the marital nature of property is retained through transmigrations. *See, e.g., Richards v. US*, 683 F2d 1219 (9th Cir 1981); *Hammonds v. Comr*, 106 F2d 420 (10th Cir 1939); *Phillips v. Comm.*, 9 BTA 153 (1927).

Commingleing. The basic presumption of the commingling doctrine is that when separate funds are commingled with community funds to purchase an asset, the asset will be community property if it is not possible to trace any of the separate funds to their original source. A common exception to the general rule is that when the community property is insignificant compared to the separate property with which it is commingled, the commingling will not result in the entire mass being deemed community. *See In re Witte's Estate*, 21 Wash 2d 112, 150 P2d 595 (1944). The exception to the commingling doctrine appears to be applied very seldom, and

is usually applied when the amount of community property is indeed insignificant. Courts are reluctant to apply this exception to the commingling doctrine because the law of most jurisdictions protects the nonacquiring spouse by favoring community property. Some courts apply a *pro rata* rule, whereby the asset is deemed to be the separate property of one spouse to a certain degree and the community property of the spouses as to the rest. In order to use this *pro rata* approach and avoid the application of the commingling doctrine, the spouse who is asserting the separate character of an asset has the burden of proving that separate property was in part the source of the asset. *See Berol v. Berol*, 37 Wash 2d 380, 233 P2d 1055 (1950).

Change in Situs of Property.

Generally, the character of movable property is fixed at the time of acquisition in accordance with the law of the marital domicile. *See Stringer v. Stringer*, 116 Wash 131, 198 P 733 (1921), *Cummings v. Anderson*, 94 Wash 2d 135, 614 P2d 1283 (1980). Oregon appears to recognize the community nature of the property brought into Oregon from another state. The Tax Court and the IRS also recognize that personal property which is community in nature does not lose its community nature when the owners move to a common law state. *See Phillips v. Comr*, 9 B.T.A. 153 (1927) *Acq.*, VII-2 CB 32, where the court recognized the community nature of those assets of the Oklahoma taxpayers that had been acquired as community property in Texas.

Manner of Taking Title. There exist federal tax law cases that both deny the step-up in basis for property interests based upon the nature of the title to the property (Rev Rul 68-80, 1968-1 C.B. 348; *Murphy v. Comr*, 342 F2d 356 (9th Cir 1965); *Crosby v. Comr*, 20 T.C.M. 1422 (1961); and *Bordenave v. US*, 150 F Supp 8320 (ND Cal 1957)), and allow the step-up in basis despite the nature of the title (*McCullum v. US*, 58-2 USTC ¶ 9957 (ND Okla 1958)). Special attention must therefore be paid to the different manners of taking title the couple have used. Laws dealing with the effect of changing title to property vary from state to state. For example, under the

Washington community property system, property to which title is taken in the name of one spouse may be the separate property of that spouse, the separate property of the other spouse, or community property, depending upon the source of funds used in purchasing the property. *Merritt v. Newkirk*, 155 Wash 517, 285 P 442 (1930). The presumption in Washington is that property acquired during marriage is community in nature and the manner of taking title, taken alone, is insufficient evidence to overcome the presumption. *Parke v. Case*, 113 Wash 263, 193 P 688 (1920), *In re Parker's Estate*, 115 Wash 57, 196 P 632 (1921). However, RCW 26.16.050 allows a person to convert his or her community real property to the separate property of his or her spouse by conveying the community interest to the spouse. Cases have applied this statute to personal as well as real property. See § 5.10 *Washington Community Property Deskbook* (2d ed 1989).

In some community property jurisdictions, joint tenancy property is not community property, and in other states it may be. In Washington, prior to 1985, if both members of the marital community joined in the creation of a joint tenancy, the community nature of the asset was destroyed. *Lambert v. Peoples Natl Bank of Washington*, 89 Wash 2d 646, 574 P2d 738 (1978); *Estate of Olson*, 87 Wash 2d 855, 557 P2d 302 (1976).

In 1984, the Washington legislature enacted RCW 64.28.040 which states that, for all joint tenancies that were created from community property and existed on January 1, 1985 or were created thereafter, the property will pass by right of survivorship but "in all other respects the interest is treated as community property."

Spouses in California may hold property as joint tenants or tenants in common as well as community property. Cal Civ Code § 5104. Property held in joint tenancy passes by right of survivorship and constitutes the separate property of each spouse as to an undivided one-half interest. See *Kaupe v. Kaupe*, 131 Cal App 2d 511, 280 P2d 856 (1955); *In re Jamesons' Estate*, 93 Cal App 2d 35, 208 P2d 54 (1949).

The Internal Revenue Service recognizes that it is possible for community property registered as a joint tenancy to pass into a common law state and retain its community nature. Rev Rul 78-418, 1978-2 CB 237. Additionally, the Internal Revenue Service recently ruled that property which constitutes community property under state law will constitute community property for purposes of IRC 1014(b)(6), regardless of the form in which title was taken. Rev Rul 87-98, 1987-39 ID 15.

Severing or Creating Community Property by Agreement. It is possible to sever community property into separate property or to convert separate property to community property by joining in a community property agreement. For example, RCW 26.16.120 provides that:

"Nothing contained in any of the provisions of this chapter or in any law of this state, shall prevent the husband and wife from jointly entering into any agreement concerning the status or disposition of the whole or any portion of the community property, then owned by them or afterwards to be acquired, to take effect upon the death of either. But such agreement may be made at any time by the husband and wife by the execution of an instrument in writing under their hands and seals, and to be witnessed, acknowledged and certified in the same manner as deeds to real estate are required to be, under the laws of the state, and the same may at any time thereafter be altered or amended in the same manner."

Case law of the applicable jurisdiction should be examined to determine whether such agreements are effective and in what manner they must be written.

Borrowed Money. Generally, money borrowed during a marriage is presumed to be community debt. It follows that the assets subsequently purchased with the borrowed money is also community in nature. See § 3.21 *Washington Community Property Deskbook* (2d ed 1989). However, the community property presumption may be overcome if the separate property of one spouse is given as security for the loan. See *Yesler v. Hochstetler*, 4 Wash 349, 30 P 398 (1892); *Heintz v. Brown*, 46 Wash 387, 90 P 211 (1907). The law of the applicable jurisdiction should be checked to determine the effect of installment payments of one nature made towards the purchase of an asset that was of the other nature when title was taken. In some jurisdictions, the result depends upon the nature of the installment purchase, *i.e.*, whether by mortgage, trust deed, or contract and upon whether the obligation was undertaken before or during the marriage and performance completed during or after the marriage.

Closely Held Business Interests. Generally, whether the increase in value of a separate business interest is community or separate in nature depends upon whether the increase arose from a spouse's services or from rents, issues and profits from the assets of the separate business. See *Hamlin v. Merlino*, 44 Wash 2d 851, 272 P2d 125 (1954). Withdrawals of reasonable salary are community in nature and withdrawals in excess of a reasonable salary may be separate in nature. Increases in the value of the business, where less than a reasonable salary is withdrawn, may be community in nature, and increases in the value of a business where a reasonable salary is withdrawn may be separate in nature.

Donna M. Muehleck

Readers with an article to publish or ideas for future newsletter articles are encouraged to contact an editorial board member.



Calendar of Seminars and Events

- April 8, 15, 22, 29, 1991 (Sponsored by Practicing Law Institute) **Basic Estate Planning Under the New Tax Law**, New York, New York. Telephone (212) 765-5700 ext. 340.
- April 22-26, 1991 (Sponsored by American Law Institute) **Planning Techniques for Large Estates**, Waldorf Astoria, New York, New York. (Registration closed; waiting list closed) Repeats: November 18-22, 1991 San Francisco, California. Telephone: (215) 243-1630 or (800) CLE-NEWS.
- May 1991 (Tentative) (Originally scheduled April 1991) (Sponsored by Southern California Tax & Estate Planning Forum) **Marital Deduction Planning**, San Francisco, California (Friday). Telephone: (619) 298-7620.
- May 1991 (Tentative) (Originally scheduled April 1991) (Sponsored by Southern California Tax & Estate Planning Forum) **Marital Deduction Planning**, Los Angeles, California (Saturday). Telephone: (619) 298-7620.
- May 7, 1991 (Sponsored by Georgetown University) **Estate Freezes ("mini session")** Georgetown University Law Center, Washington, D.C. Telephone: (202) 662-9010.
- May 13 & 14, 1991 (Sponsored by New York University) **Trusts & Estates**, Grand Hyatt Hotel, New York, New York. Telephone: (212) 790-1320.
- May 14, 1991 (Sponsored by Oregon Tax & Planning Institute) **1991 Tax & Planning Seminar**, Jantzen Beach Red Lion Hotel, Portland, Oregon. Telephone: (503) 321-7400.
- May 31, 1991 (Sponsored by American Law Institute) **Marital Deduction Skills Workshop**, Copley Plaza Hotel, Boston, Massachusetts. Telephone: (215) 243-1630 or (800) CLE-NEWS.
- June 6 & 7, 1991 (Sponsored by National Law Foundation) **Estate Freeze - Generation Skipping Trusts-Recent Estates, Gifts & Trust Development**, Penta Hotel, New York, New York. Telephone: (302) 656-4757.
- June 10 & 11, 1991 (Sponsored by World Trade Institute,) **International Tax and Estate Planning**, World Trade Center, New York, New York. Telephone: (212) 466-4044.
- June 17-21, 1991 (Sponsored by American Law Institute) **Estate Planning in Depth**, University of Wisconsin, Madison, Wisconsin. Telephone: (215) 243-1630 or (800) CLE-NEWS.
- June 20 & 21, 1991 (Sponsored by National Law Foundation) **Comprehensive Estate, Gifts & Trusts Workshop**, Caesar's Hotel, Atlantic City, New Jersey. Telephone: (302) 656-4757.
- October 1 & 2, 1991 (Sponsored by National Law Foundation) **Annual Fiduciary Tax Conference**, Penta Hotel, New York, New York. Telephone: (302) 656-4757.
- October 9-12, 1991 (Sponsored by Southern California Tax & Estate Planning) **11th Annual Southern California Tax & Estate Planning Forum**, Meridien Hotel, San Diego, California. Telephone: (619) 298-7620.
- October 17 & 18, 1991 (Sponsored by Washington State Bar - Estate Planning Council of Seattle) **Estate Planning 1991**, Washington State Convention & Trade Center, Seattle, Washington. Telephone: (206) 448-0433.
- October 27 - November 1, 1991 (Sponsored by Hawaii Tax Institute - Chaminade University of Honolulu) **28th Annual Hawaii Tax Institute** (Includes Estate Planning 10/27 & 28), Hawaiian Regent Hotel, Waikiki, Oahu, Hawaii. Telephone: (808) 946-2966.
- November 18-22, 1991 (Sponsored by American Law Institute) **Planning Techniques for Large Estates**, San Francisco, California. Telephone: (215) 243-1630 or (800) CLE-NEWS.



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Third Restatement of Trusts: The Prudent Investor Rule

The American Law Institute has recently approved the proposed final draft of the Restatement (Third) of the Law on Trusts.¹ The Third Restatement presents a modernization of the prudent man rule as it relates to investments by a trustee. The standard of a "prudent investor" has been substituted for the more traditional "prudent man" rule. The Third Restatement amends several existing sections of the Second Restatement of Trust and adds additional comments. It is not a completely rewritten version.

The objectives of the Third Restatement's prudent investor rule are to allow the appropriate use and flexibility of modern investment experience and theories, including modern portfolio theory, in the development of investment strategies by trustees. The change represents an evolution in the prudent man rule as it relates to trust investments. The traditional prudent man doctrine continues to change as evidenced by several individual states which have changed the rule by statute.² Statutory prudent investor type standards have also been included in the Uniform Management of Institutional Funds Act (UMIFA), and the Employee Retirement Income Security Act of 1974 (ERISA).

Under the traditional prudent man standard, the measure of a trustee's conduct is what the trustee would consider reasonable in making investments of his or her own property and in accordance with the trust instrument and applicable statutes. The modernization of the prudent man rule compares the conduct of a trustee investing trust assets with the actions of a prudent investor acting with similar funds and under similar circumstances.

General Rule of Prudence

The Third Restatement prudent investor rule states:

"The trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements and other circumstances of the trust."

Restatement (Third) of Trusts, §227.

Using a "prudent investor" as the standard to be emulated recognizes that there is no one universally accepted theory of financial investing. Varied approaches to the prudent investment of trust funds are permitted. While no investment strategies or techniques are imprudent *per se*, the following principles will generally apply:

- 1) Prudent risk management generally requires sound diversification;
- 2) Trustees must make conscious decisions concerning the levels of risk versus the expected returns which are appropriate for the trust based upon the particular purposes and requirements of the trust;
- 3) Trustees have a duty to avoid unjustified fees, transaction costs and other expenses;
- 4) The duty of impartiality requires a balancing of the elements of return between the income investments of the trust and the purchasing power of the corpus; and
- 5) The trustee may have a duty to delegate to the same extent a prudent investor would delegate in similar circumstances.

Of course, specific actions of a trustee may also be required or limited by the specific terms of the trust or specific statutes.

The Oregon standard on investments by fiduciaries is contained in ORS 128.057, and states in pertinent part:

"... a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital..."

Oregon follows the prudent man standard. However, Oregon does recognize that individual investments are to be reviewed with reference to the entire trust portfolio.³

While Oregon case law has cited the Second Restatement in discussions of the prudent man rule⁴, the Oregon Supreme Court has expressly noted that the Restatement is not and does not purport to be the law in Oregon or any other state.⁵ In *Duyck v. Tualatin Valley Irrigation Dist.*, the Court addressed the parties' references to the Restatement as follows:

"* * *

The Restatement is not, nor does it purport to be, the law of this state or any other state. *Brewer v. Erwin*, 287 Or 435, 455 n 12, 600 P2d 398 (1979). Mere reference to the Restatement does not "substitute for an independent analysis and presentation of the elements that make, or should make, defendants liable under Oregon law, when the relevance of some of the elements to a theory of liability is an open question in this state." *U.S. National Bank v. Fought*, 291 Or 201, 227, 630 P2d 337 (1981) (Linde, J.,

concurring)." 304 Or at 156 n 3. It is not likely that the Oregon courts will modify the interpretation of ORS 128.057 to incorporate the concepts of the Third Restatement. Any substantial change will have to be made at the legislative level.

There is little Oregon case law addressing a trustee's duty to make prudent investment decisions⁶. Neither the Oregon statute nor the case law gives a trustee, or a practitioner advising a trustee, much guidance in assessing the issues of modern portfolio management which the Third Restatement attempts to address. While an Oregon practitioner may not wish to rely upon the flexibility permitted by the Third Restatement, the new provisions and the accompanying comments are very instructive in analyzing the many issues facing a fiduciary investing trust assets.

The investment of retirement plan assets is subject to ERISA, not Oregon law. The Third Restatement is more instructive in the retirement plan area because the ERISA fiduciary standard incorporates many of the concepts discussed in the Third Restatement.⁷

Standard of Care Required

A. Generally.

The prudent investor rule in the Third Restatement requires:

"(a)...[t]he exercise of reasonable care, skill and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust.

(b) In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so." Restatement (Third) of Trusts, §227.

The duty of care requires the trustee to exercise reasonable effort and diligence in making and monitoring investments of the trust, with attention to the trust's objectives.

B. Formulation of Investment Strategy.

The test of prudence is one of conduct and not one of investment performance. If the trustee adopts a sound investment strategy including appropriate risk management factors and implements the strategy with the required degree of care and skill, the trustee will have complied with the fiduciary standards. Such compliance is judged at the time the investment decision in question is made, and not with the benefit of hindsight based upon the actual performance of the investment. However, it must be recognized that the trustee may have continuing obligations to review a

particular investment decision and make additional decisions on whether to retain or dispose of a particular investment.

The comments of the Third Restatement require that the trustee exercise care in both the formulation and the implementation of an appropriate investment strategy. Investments must be selected and reviewed in a manner reasonably appropriate to that strategy. The exercise of care requires that the trustee obtain relevant information about the circumstances and requirements of the trust and its beneficiaries, the contents and resources of the trust estate and the available investment alternatives. The exercise of care may also require the trustee to secure and consider the advice of others if seeking advice would have been required of a reasonable investor under the circumstances.

C. Degree of Skill Required.

Generally, the trustee is required to use the skill of an individual of ordinary intelligence. However, a higher degree of skill may be required in the following situations:

1) If the trustee possesses a degree of skill greater than that of an individual of ordinary intelligence, then the trustee must make reasonable and diligent use of that skill;

2) If a trustee, such as a corporate or professional trustee, expressly or implicitly represents that it has greater skill or special facilities for investment management, the trustee must make reasonable and diligent use of that skill or those special facilities; and

3) If the trustee employs an investment strategy which requires knowledge and experience greater than that of an individual of ordinary intelligence, then the trustee must exercise the care and skill in investment management required by the strategy.

A person of ordinary intelligence may serve as a trustee if that person takes reasonable steps to obtain, to the extent necessary, sufficient and competent advice, guidance and assistance in order to formulate and implement a prudent investment strategy for a particular trust. For example, an investment strategy could include professionally managed mutual funds or other investment pools with complex strategies utilizing options or futures trading. A person who serves as trustee should be capable of reasonably understanding the basic duties of prudent trusteeship. The comments to the Third Restatement suggest that simple written guidelines prepared by legal counsel may be helpful for reference or presentation by an inexperienced trustee when conferring with an investment advisor.

The prudent investor rule does not

prevent a trustee from pursuing a particular investment strategy merely because the strategy is demanding, as long as the strategy is appropriate both for the purposes and circumstances of the trust and to the skills possessed by or available to the trustee.

D. Delegation of Duties.

The trustee is specifically authorized and may in fact have the duty to delegate authority to others in the implementation of the strategy to the extent a prudent investor would have such authority or duty in similar circumstances. In delegating authority, the trustee must exercise appropriate care and skill in selecting and supervising agents and in determining the degree and terms of the delegation.

E. Duty of Caution.

The duty of caution requires the trustee to exercise the caution a prudent investor would exercise in managing similar funds for similar purposes. The requirement of caution considers both the safety of the capital and the requirement to secure a reasonable return. The comments to the Third Restatement specifically require consideration of the loss to the trust estate's purchasing power which results from inflation as a risk to the safety of the capital. Reasonable "return" includes not only trust accounting income but also the capital appreciation which may be necessary for the preservation of purchasing power. The capital growth element may also extend to growth in the real value of the principal in appropriate cases. The trustee may consider the purposes and distribution requirements of the trust and the respective beneficiaries' tax positions in balancing the return objectives between the flow of income and the growth of principal.

It is expressly recognized that an effort to preserve the purchasing power may result in some increased risk to the trust. However, the duty of caution does not call for the avoidance of risk by trustees, but rather the prudent management of risk. Risk management must take into account all hazards, including the risks of inflation, volatility of price and yield, lack of liquidity, etc.

F. Risk Management.

The comments to the Third Restatement state that the trustee is required to give careful attention to the particular trust's risk tolerance. Subjective judgments then must be made addressing the appropriate degree of risk to be undertaken considering the resulting higher or lower level of expected return resulting to the trust portfolio. While diversifiable risk should be reduced to a minimum, appropriate degrees of market risk may be acceptable if compensated by expected higher returns.

Diversification is fundamental to the management of risk and is a pervasive consideration in prudent investment management. The duty to diversify applies to the entire portfolio as well as within portions of a trust portfolio having assets of a particular type or having special characteristics. However, special considerations may make it prudent not to diversify in a particular trust situation.

While the comments recognize that a general duty to invest conservatively is a traditionally accepted feature of trust law, beneficiaries can also suffer losses because of undue conservatism. Compensated risk is not inherently bad. The duty of prudent investing requires the trustee to recognize the need to balance the trust return requirements with its tolerance for volatility. The purposes and circumstances of the trust and beneficiaries must be considered in the process.

The comments to the Third Restatement specifically note that active management strategies and competent use of investments or techniques that are often characterized as risky or "speculative" are not necessarily prevented by the prudent investor rule. For example, investments such as real estate and venture capital or techniques such as borrowing, options or futures transactions are not prohibited as long as they are employed in a manner that is prudently designed to reduce overall risk of the trust portfolio. These investments would also be permitted if they were employed in a manner and in appropriate circumstances to achieve a higher return expectation without a disproportionate increase in the overall risk level of the portfolio. The requirement of caution is summarized in the comments as follows:

"...The prudent investor rule, despite its requirement of caution, does not classify specific investments or courses of action as prudent or imprudent in the abstract. The rule recognizes that what may be under-productive of trust accounting income or risky—or even characterized as speculative—in isolation, or in a different context, may play a role in an investment strategy that contributes to the trustee's compliance with the requirement of caution...."

Conclusion

The practitioner advising a trustee investing trust assets, whether it is an institutional trustee or an individual trustee of a family trust, may find the comments to the Third Restatement instructive in analyzing problems faced by the trustee. Specific attention should be paid to particular duties and procedures involving the implementation of investment and risk management plans

which are expected of a prudent investor. The additional flexibility given to the investments which a trustee acting under the prudent investor standard may make will be more difficult to implement because of the restraints of existing trust instruments and existing state law.

Leslie L. Wellman
Shari J. Clark

Footnotes

- 1) The Third Restatement is expected to be published sometime in the Summer of 1991. The proposed final draft was adopted by the ALI in May, 1990, with only minor changes. For copies of the proposed final draft, call 1(800)CLE-NEWS, or write to: The Executive Office, American Law Institute, 4025 Chestnut Street, Philadelphia, PA 19104.
- 2) California Probate Code § 16040(b) (1986); Delaware Code Ann., tit. 12, § 3302 (1986); Georgia Code Ann. § 53-8-2 (1988); Tennessee Code Annotated § 35-3-117 (1989); Minnesota Statutes § 501.125, subd. 1 (1987); Washington Rev. Code § 11.100.020 (1984).
- 3) *U.S. Nat. Bank v. First Nat. Bank*, 172 Or. 683, 142 P.2d 785, 143 P.2d 909 (1943).
- 4) *Id.*, at 704.
- 5) *Duyck v. Tualatin Valley Irrigation Dist.*, 304 Or. 151, 156, 742 P.2d 1176 (1987).
- 6) For cases discussing investment decisions in Oregon, see, *Stephan v. Equitable Sav. & Loan Ass'n.*, 268 Or. 544, 522 P.2d 478 (1974); *U.S. Nat. Bank v. First Nat. Bank*, *supra*; *Driver v. Blakeley*, 165 Or. 312, 107 P.2d 524 (1940); *Kinney v. Uglow*, 163 Or. 539, 98 P.2d 1006 (1940); *Marshall v. Frazier*, 159 Or. 491, 80 P.2d 42 (1938); *Hull v. Heimrich*, 138 Or. 117, 3 P.2d 758, *modified and rehearing denied*, 138 Or. 117, 6 P.2d 41 (1931); *Boehmer v. Silverstone*, 95 Or. 154, 186 P. 26 (1920); *In re Roach's Estate*, 50 Or. 179, 92 P. 118 (1907); *Mest v. Dugan*, 101 Or.App. 196, 790 P.2d 38, *rev. den.*, 310 Or. 133 (1990); *Wadsworth v. The Bank of California*, 97 Or.App. 491, 777 P.2d 975, *rev. den.*, 308 Or. 593 (1989); *Jarrett v. U.S. National Bank of Oregon*, 81 Or.App. 242, 725 P.2d 384, *rev. den.*, 302 Or. 476, 731 P.2d 442, *appeal after remand*, 95 Or.App. 334, 768 P.2d 936 (1986); *Hatcher v. United States Nat. Bank of Oregon*, 56 Or.App. 643, 643 P.2d 359, *rev. den.*, 293 Or. 373 (1982).
- 7) ERISA § 404; 29 U.S.C. § 1104.

Estate Planning and Administration Section Annual Meeting

The Annual Meeting of the Estate Planning and Administration Section will be held during the Oregon State Bar Annual Meeting at Seaside, Oregon. The meeting will be held on October 3, 1991 at 5:00 p.m. The location will be announced. All Section members are encouraged to attend. Formal notice of the meeting will be sent to all Section members at a later date.

Update: Small Estate Affidavits

Under ORS 114.525(11) and ORS 114.545(1)(b), the affiant is required to

mail or deliver a copy of a Small Estate Affidavit to the Adult & Family Services Division, Estate Administration Section within 30 days after the affidavit is filed with the court.

Recently, certain functions of the Adult & Family Services Division were transferred to the Senior Disabled Services Division. This transfer included estate administration and, therefore, the responsibility for receiving Small Estate Affidavits. See 1989 Or. Laws, ch. 787, §2(6)(b).

The Senior & Disabled Services Division has indicated that it has not been receiving copies of all Small Estate Affidavits which have been filed in Oregon. The correct address for mailing the copy of the affidavit to the Division is:

Estate Administration Unit
Senior & Disabled Services Division
P.O. Box 14021
Salem, OR 97309

All practitioners should make sure that a copy of the affidavit is mailed or delivered to the Division in a timely manner. Failure to do so will prolong the period of time during which the Division can file a claim against the estate and may otherwise complicate the administration.

Daniel C. Re

Tax Developments

IRS Letter Ruling 9113009 - Guaranties of children's loans held to be taxable transfers for gift tax purposes.

Taxpayer had adult children who acquired equity positions in various target companies. The consideration paid in acquiring the target companies was financed through loans obtained from banks or other commercial lenders. The lenders required that taxpayer guarantee the loans of the acquiring entities. Taxpayer stated that, without the guaranties, the shareholders would not have been able to obtain the loans or at least would have had to pay a higher interest rate on the loans.

The Service ruled that the guaranties executed by taxpayer on behalf of the shareholders were transfers subject to gift tax, reasoning that the gift tax was designed to encompass all transfers of property and property rights having significant value. Because the guaranties conferred a valuable economic benefit on the shareholders, they constituted gift transfers.

Technical Advice Memorandum 9117003 - Gifts made from revocable trusts within three years of death.

Six years before his death, taxpayer set up a revocable trust which provided that,

during taxpayer's lifetime, the trustee was to pay net income to taxpayer or to otherwise pay or apply net income as taxpayer may direct. The trustee was also required to pay to taxpayer all or any part of the trust principal as taxpayer requested. Taxpayer made gifts of cash directly from the revocable trust to his grandchildren, children and in-laws. Gifts of both income and principal were made from the trust within three years of taxpayer's death, which occurred in 1988.

The Service ruled that the gifts of income, but not principal, made within three years of taxpayer's date of death were includable in taxpayer's estate for death tax purposes. The Service ruled that the gifts of income were includable under §2035(d)(1) as constituting transfers which would have been included under IRC §2038 if such interests had been retained by the taxpayer. The taxpayer's estate argued that the gifts of income were never transferred by the taxpayer to the trust, but that the income had been earned after the transfer of property to the trust had taken place. The Service disagreed, stating that because income remaining in the trust on taxpayer's death would have been includable in his estate under IRC §2038, all income earned after the trust's creation would be treated as transferred to the trust by the taxpayer, with a retained power to alter, amend or revoke. Thus the distribution of income to persons other than taxpayer acted as a relinquishment of the decedent's right to revoke to that extent. However, since, under the terms of the trust agreement, trust corpus was distributable only to the taxpayer, the Service deemed those transfers as withdrawals of corpus by taxpayer followed by transfers to the donees.

Calendar of Seminars and Events

- August 2, 1991 (Sponsored by Professional Education Systems, Inc.) **Oregon/Federal Fiduciary Income Tax Workshop**, Portland Hilton, 920 SW 6th Ave., Portland, Oregon, Telephone: 1-800-843-7763
- September 12-13, 1991 (Sponsored by ALI-ABA) **Sophisticated Estate Planning Techniques**, Westin Hotel, Boston, Massachusetts, Telephone: (215) 243-1630
- September 13, 1991 (Sponsored by Willamette University College of Law) **12th Annual Willamette Tax Conference**, Portland, Oregon, Telephone: (503) 370-6380
- September 25, 1991 (Sponsored by Oregon State Bar) **Automating the Drafting of Wills and Trusts (satellite)**, Oregon State Bar Center, 5200 SW Meadows Rd, Lake Oswego, Oregon, Telephone: (503) 620-0222
- September 27, 1991 (Sponsored by Oregon Law Institute) **Estate and Trust Litigation**, World Trade Center, 25 SW Salmon, Portland, Oregon, Telephone: (503) 243-3326
- October 1-2, 1991 (Sponsored by National Law Foundation) **Annual Fiduciary Tax Conference**, Penta Hotel, New York, New York, Telephone: (302) 656-4757
- October 9-12, 1991 (Sponsored by Southern California Tax & Estate Planning) **11th Annual Southern California Tax & Estate Planning Forum**, Meridien Hotel, San Diego, California, Telephone: (619) 696-6773
- October 17-18, 1991 (Sponsored by Washington State Bar - Estate Planning Council of Seattle) **Estate Planning 1991**, Washington State Convention & Trade Center, Seattle, Washington, Telephone: (206) 448-0433
- October 27-November 1, 1991 (Sponsored by Hawaii Tax Institute - Chaminade University of Honolulu) **28th Annual Hawaii Tax Institute (Includes Estate Planning 10/27-10/28)**, Hawaiian Regent Hotel, Waikiki, Oahu, Hawaii, Telephone: (808) 946-2966
- November 8, 1991 (Sponsored by Oregon State Bar Estate Planning and Administration Section) **Administering Oregon Estates**, Oregon State Bar Center, 5200 SW Meadows Rd, Lake Oswego, Oregon, Telephone: (503) 620-0222 Ext. 407
- November 18-22, 1991 (Sponsored by American Law Institute) **Planning Techniques for Large Estates**, San Francisco, California, Telephone: (215) 243-1630
- December 18, 1991 - Tentative (Sponsored by Washington State Bar) **How to Draft Wills and Other Estate Planning Documents**, Spokane Sheraton (at Seattle Westin Hotel on December 20, 1991), Telephone: (206) 448-0433
- January 1-2, 1992 (Sponsored by National Law Foundation) **Estate Planning Seminar**, Frenchman's Reef Hotel, St. Thomas, Virgin Islands, Telephone: (302) 656-4757
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newsletter

Oregon Estate Planning
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1991 Estate Planning and Administration Legislation

Introduction

The 1991 Session of the Oregon Legislative Assembly enacted a number of bills affecting estate planning and administration. The purpose of this article is to give members of the section an advance look at legislation which will affect their practice. This summary should guide you to new statutes you may wish to study in more detail. Unless otherwise indicated, all statutes became effective September 29, 1991.

I. Decedents' Estates

A. HB 2266 (Ch 704)

Will Contest and Contract to Make a Will Procedures Revised; Supplemental Notice of Probate

HB 2266 was introduced at the request of the Estate Planning and Administration Section of the Oregon State Bar with two primary purposes in mind. The first was to relax the statute of frauds for contract to make a will cases, ORS 112.270. The second was to establish clear procedures for both contract to make a will cases and will contests which would meet the due process requirements illustrated by *Tulsa Professional Collection Services v. Pope*, 485 US 478, 108 SCt 1340, 99 LEd2d 565 (1988). The first purpose was eliminated in the House Judiciary Committee, and the bill became a purely procedural revision making no substantive changes in the law.

To comply with the notice requirements of *Tulsa*, ORS 113.035 now requires that any person known to the petitioner in a probate proceeding to have a potential will contest or contract to make a will interest in the estate be named in the petition, and ORS 113.145 now requires that such persons be served a copy of what was formerly the Information to Heirs and Devisees.

Under previous law Information to Heirs and Devisees was only required for those named in the petition. ORS 113.145 is amended to require such notice to all heirs, devisees, and the additional parties now entitled to notice who were *required* to be named—i.e., those “known” to the petitioner, whether or not listed—and further to require notice to those of whom the personal representative receives actual knowledge during administration. This conforms to the due process requirements of *Tulsa*.

Contract to make a will cases previously fell into an undefined procedure somewhere between claims and will contests. The procedure for such cases is now defined by ORS 113.075 as very similar to will contests, except that they may be brought outside the probate court in order to enable either party to demand a jury trial.

New rules for calculating time limits

for commencing will contests and contract to make a will cases are established in ORS 113.075. Consistent with the new requirement of notice, the time limit in most cases will run from the giving (not the receipt) of notice, if notice is required, or from publication, if notice is not required. The time limit remains at four months.

One significant change came in the conference committee on the bill to resolve differences between the House and Senate versions. The original bill would have eliminated the fraudulent promise to make a will cause of action allowed in *Hocks v. Hocks*, 95 Or App 40 (1989). The Senate version dropped the provision. The conference committee bill which was ultimately adopted followed the Senate version in this respect, but it went on to provide in new ORS 113.075(4) that *Hocks*-type actions may not be brought as claims. Thus the new contract to make a will procedure in ORS 113.075 becomes the exclusive means of pursuing such a cause of action.

Section 4 of the act provides that it applies to probate proceedings commenced on or after the effective date (September 29, 1991), except that the new time limits do not apply to preexisting causes of action protected from the old statute of limitations by the principles of *Tulsa* until July 1, 1992.

B. SB 175 (Ch 191)

Personal Representative's Deed Replaces Abstract of Probate

Since 1987, ORS 113.165 has required a personal representative filing an inventory including Oregon real property to record an abstract of probate in the deed records. ORS 116.223 required that the decree be recorded in counties other than the county of probate when real property was distributed from an estate. This left the assessor in the county of probate with no notice of the name and address of the distributee who would pay the tax in the future, and the assessor in other counties with only a name. The result (especially given widespread ignorance by the bar of the abstract requirement) was that tax bills and other notices were not delivered.

This Department of Revenue bill eliminates the requirement of an abstract of probate, but requires recording of a personal representative's deed for all real property distributed from an estate, including that in the county of probate. Unfortunately (given the higher cost for recording deeds) the option of an abstract was not preserved.

If it is anticipated that real property will be tied up in a lengthy probate it would remain advisable to record an abstract of probate when the inventory is filed to assure that the personal representative will receive tax notices. This will assure both notice of (and the opportunity to appeal) assessment increases and the opportunity to receive the 3% discount on timely payment of the tax.

The act makes similar changes in the Small Estate Law.

C. *HB 2376 (Ch 306)*
Uniform Transfer-on-Death Security
Registration Act

This uniform law expands the available probate avoidance systems with respect to securities by allowing both individual securities and "street name" accounts to be registered in a form under which the owner retains full control over the account during life, but a beneficiary succeeds to ownership on death without probate. This eliminates the numerous potential problems associated with use of joint ownership to avoid probate.

This act was the subject of official commentary by the National Conference of Commissioners on Uniform State Laws at its adoption by them in 1989 and is also discussed at length in Wellman, "Transfer-on-Death Securities Registration: A New Title Form," 21 *Ga L Rev* 709 (1987).

Prior to using this form, consideration should be given to the effect of subsection (2) of Section 9, which provides that the act does "not limit the rights of creditors of security owners against beneficiaries and other transferees under other laws of this state." In the official commentary it is suggested that, "Consideration should be given to the desirability of adapting the section as necessary to fit local principles regarding the rights of a surviving spouse to protection against disinheritance by nonprobate transfers effective at death." If that consideration was given, it is not apparent on the face of the statute as enacted. However, it appears that this section has the effect of making transfers under the act subject to the remedies of the Uniform Fraudulent Transfer Act, ORS Ch 95.

II. Wrongful Death

A. *HB 2354 (Ch 608)*
Extends Wrongful Death Statute of Limitations
to 3 Years from Discovery or Death

This act incorporates a discovery rule into ORS 30.020, effectively overruling *Eldridge v. Eastmoreland General Hospital*, 307 Or 500 (1989). The new time limit for commencing a wrongful death action is three years from discovery of the injury causing death. However, the act creates a new statute of ultimate repose at three years from the date of death. It also incorporates by a general reference all other statutes of ultimate repose that might bar the action.

B. *HB 2593 (Ch 471)*
Allows Wrongful Death Recovery by Stepchild
or Stepparent

This OTLA-sponsored act extends the classes of persons entitled to share in the proceeds of a wrongful death cause of action to include stepchildren and stepparents.

After the bill passed the House, the sponsors recognized significant problems in defining these relationships and added definitions at ORS 30.020(4). Under these provisions the stepparent-stepchild relationship must be created while the stepchild is a minor and in the custody of

the "biological" parent who marries the stepparent, and it does not survive divorce of the stepparent and "biological" parent.

Apparently the writers of the Senate corrective amendments never heard of adoption or considered the practical realities of joint custody. It can be anticipated that there may be difficulties applying the statute in those situations, which will not be helped by legislative history. In the adoption situation any question should be resolved by ORS 109.350, which provides that an adopted child is "to all legal intents and purposes" the child of the adoptive parents. However, the "biological" language in the act is troubling, especially since it was completely unnecessary.

III. Incapacitated Persons

A. *HB 2708 (Ch 546)*
Temporary Guardians

In *Grant v. Johnson*, 757 F Supp 1127 (D Or 1991) Judge Helen J. Frye ruled ORS 126.133 unconstitutional for failure to provide due process to persons subject to temporary guardianship proceedings. This act is intended to correct the deficiencies found by the federal court.

Amended ORS 126.133(2) now requires at least two days' notice to the proposed protected person prior to appointment of a temporary guardian. ORS 126.133(5) was amended to require a hearing on request and within two days of demand. An exception to the advance notice requirement is made by ORS 126.133(2) in the event an "emergency requires immediate appointment," in which case notice must be given within two days after appointment. An "emergency" is defined by new ORS 126.003(3) to mean "an immediate and serious danger to life or health." It is noteworthy that under ORS 126.133(1) an "emergency" remains a prerequisite to appointment of a temporary guardian. It would appear almost invariably that a case calling for a temporary guardian would allow waiver of the advance notice requirement.

ORS 126.133(1) was amended to require that the "specific finding" on which a temporary guardianship is based be established by "clear and convincing evidence" and also to impose a new 30-day time limit on temporary guardianships. Under ORS 126.133(3) this time may on good cause be extended by 30 days.

The statute does not specify whether a court can appoint a temporary guardian 48 hours after notice is given, even though a hearing has just been requested and will not be held until two days later. New ORS 126.133(4) provides that a visitor must be appointed only if no hearing is requested. However, a hearing could eliminate the need for a visitor, so ORS 126.133(4) is not decisive as to whether the scheduling of a hearing forecloses immediate appointment.

ORS 126.103 is amended to allow appeals from orders appointing temporary guardians and to provide for continuation of

the guardianship during appeal.

The statute contains an emergency clause which made it effective on July 14, 1991.

B. *HB 2709 (Ch 895)*
Guardians and Conservators

Amended ORS 126.050 adds the requirement in both guardianship and conservatorship proceedings that a person nominated or appointed as a guardian/conservator inform the court of a conviction of a Class A misdemeanor or the filing of a petition for relief under bankruptcy laws. Prior to this the only disclosure required was of a felony conviction. As before, the disclosure does not per se disqualify the nominee, but allows the court to evaluate whether the facts underlying the conviction or bankruptcy filing are such as to give rise to a reasonable belief that such person will be unfaithful to or neglectful of trust or to suggest that the appointment will not be in the best interests of the proposed incapacitated or protected person.

ORS 126.103, relating to guardianships, is amended to require that the original petition disclose whether the proposed guardian is a public or private agency or organization or employee thereof which provides services to the alleged incapacitated person. A similar amendment is made to ORS 126.183, relating to conservatorships. However, in many cases such disclosure will disqualify the nominee under another new law, section 1 of 1991 Or Laws ch 413, discussed below.

The remaining provisions of this act relate only to guardianship proceedings.

Amended ORS 126.098 includes language that an incapacitated person retains the right to contact and retain counsel and have access to personal records, and amended ORS 126.127 requires that the notice of the proceedings served on an alleged incapacitated person contain an expanded statement of these rights. Consistent with these new rules, ORS 126.137(6) is added to provide that, "A guardian may not prevent the ward from contacting or retaining counsel, or releasing records to counsel."

Amended ORS 126.103 also now directs that, except as otherwise provided by law, the visitor must submit a written report to the court within thirty days of being appointed. It further prohibits the visitor from serving the required notice of the proceeding except in a temporary guardianship proceeding.

This act contains an emergency clause and became effective on August 7, 1991.

C. *SB 510 (Ch 744)*
Reporting Abuse of Mentally Ill or Disabled
Adults

This act creates a comprehensive system for reporting abuse of mentally ill or developmentally disabled adults. It appears to be modeled loosely on the child abuse reporting law, ORS 418.740. Reporting by

any "public or private official who has reasonable cause to believe" abuse has occurred is mandatory. Attorneys are included in the definition of "public or private official," but under section 3(2) information obtained in an attorney-client relationship need not be reported.

It is noteworthy that the conference committee report adopted when the bill was passed adds section 3a, requiring an interim committee study of the professional exemption.

D. SB 682 (Ch 413)

Limits Authority of Management of Residential Care Facilities

This act resulted from an AARP bill and states several limits on the authority of residential care facilities over residents. Of significance to attorneys planning for residents of such facilities is the prohibition on owners, administrators and employees of the facilities from serving as guardian, conservator, trustee or attorney-in-fact for unrelated residents.

Of significance to attorneys representing these facilities is the requirement that the facilities establish separate trust accounts for resident funds and maintain records of resident funds and property.

E. SB 787 (Ch 761)

Requires Health Care Facilities to Provide Health Care Decision Information

The 1991 session labored long and hard over the problems with the 1989 Health Care Power of Attorney law. The only result of the several bills before the session was this act, which requires health care organizations to maintain written policies to assure that patients are informed on health care decision-making procedures and that they receive copies of the directive to physician and health care power of attorney forms.

IV. Fiduciaries

A. SB 722 (Ch 968)

Statute of Limitations for Breach of Express Trust

Section 4 of this act (which generally demonstrates the weakness of the constitutional requirement that legislative bills relate to one subject only) requires that actions against a trustee for breach of an express trust, whether in contract, tort or otherwise, be commenced within six years of discovery, but in any event within the later of ten years of the act or omission or two years after termination of any fiduciary account established under the trust.

B. SB 798 (Ch 336)

Trust Record-Keeping Rules for Banks

This bill was submitted at the request of the Oregon Bankers Association. While on its face it imposes a duty to maintain records of fiduciary accounts until three years after termination of the fiduciary relationship, its purpose was to establish a basis under Comptroller of the Currency regulations to destroy the records after three years.

C. SB 832 (Ch 353)

Investment Limits on Bank Trust Departments

This Oregon Bankers Association bill reconciles two inconsistent statutes to allow bank trust departments holding trust funds pending investment or distribution to be deposited in the same bank, provided security is given to the trust department. It also contains new and very general language prohibiting investment of bank trust department funds with individuals or organizations where "there exists an interest" which might affect the exercise of judgment by bank.

D. HB 2990 (Ch 620)

Principal and Income Act Rules on Bond Premiums and Discounts

This Oregon Bankers Association bill eliminates the prohibition in the Principal and Income Act on amortization of bond premiums and accumulation for discount. The purpose is to conform fiduciary accounting practices to tax accounting requirements.

E. HB 3349 (Ch 680)

Fiduciary Liability for Pollution Cleanup

As initially proposed, this Oregon Bankers Association bill would have exempted lenders and fiduciaries in certain circumstances from liability for pollution cleanup. As finally enacted, the law requires the Environmental Quality Commission to promulgate such rules. As of this writing the rules have not been issued.

V. What Was Not Done

As happens every session, many bills relating to estate planning and administration were introduced and not passed. As you may have read in the August issue of "For the Record," one defeated bill would have allowed "independent legal technicians" to provide estate planning and administration services directly to the public. This section is intended to give you some flavor of other defeated bills in the 1991 session.

Enactment of Measure 5 brought efforts to raise money for pet projects in connection with probate. Two bills would have added alternative dispute resolution fees to the cost of probate proceedings. Another bill would have imposed a 12% inheritance tax and dedicated the proceeds to various projects for seniors. None of these bills ever left committee.

Two section bills died in the House Judiciary Committee. One would have allowed use of written memoranda separate from wills to dispose of personal property. That bill floundered on concern of attorneys on the committee over use of such informal procedures to dispose of such items as expensive artworks. Another section bill would have reconciled the inconsistent provisions for disposition of human remains in ORS 97.130 with those for making anatomical gifts under the Uniform Anatomical Gift Act, ORS 97.250, et seq. Thanks to the opposition of Oregon funeral

directors, the whole is not necessarily the sum of the parts, and it is possible to have legal disputes when a decedent's gift of a body part is opposed by a family member with authority to dispose of the body.

Numerous bills aimed at clearing up the problems with the Health Care Power of Attorney died in the dispute over euthanasia, and it is possible that the Hemlock Society will mount an initiative campaign on this subject similar to the one that has already resulted in a measure to be voted on later this year in Washington.

The two bills on guardianships and conservatorships that were enacted were not followed into law by a number of bills which would have imposed much more stringent restrictions. With support for such bills coming from the AARP, they received a respectful hearing in the 1991 session, but no more votes than they deserved.

Finally, for those of you who still remember such things from law school, there was a bill to repeal ORS 112.345, thus reinstating the Rule in Shelley's Case.

It can be anticipated that many of these bills, along with a new crop, will be back before the Legislative Assembly in 1993, where they will again merit the close attention of the section.

Warren C. Deras

Carol Kyle

Legislation Subcommittee

Newsletter to Start Advice Column

Beginning with the January 1992 issue, the Newsletter staff will offer general advice to questions related to estate planning and estate administration. Readers are encouraged to submit questions at the following address:

Attn: Editor
Oregon Estate Planning and
Administration Section Newsletter
P.O. Box 1151
Bend, OR 97709-1151

The name of the person submitting the question will not be published.

All questions received at least 60 days before a Newsletter publication date will be considered for publication and response in the next issue of the Newsletter. The Newsletter reserves the right to respond only to those questions approved by a majority of the editorial board and to edit letters to conform to its form and length requirements. The response will not necessarily represent the position of the Section or its Executive Committee, nor is it intended to constitute the giving of legal advice.

Tax Development:

Estate of Maria Cristofani, 97 TC No. 5 (1991)—Permitted Crummey Powerholders

Decedent established an irrevocable trust of which her children were primary, and her grandchildren, contingent beneficiaries. The trust instrument provided that the two children and five grandchildren possessed rights to withdraw contributed amounts from the trust not to exceed the annual exclusion amount under IRC §2503(b). In each of the two years prior to her death, decedent conveyed to the trust undivided interests in improved real property worth \$70,000. Decedent claimed annual exclusions for all of the trust beneficiaries, vested and contingent, for each of the years in which the transfers occurred. The Service disallowed the annual exclusions taken for the gifts made to decedent's grandchildren, ruling that they were not transfers of present interests for purposes of the annual exclusion.

The tax court held against the Service, focusing on the legal right of the minor beneficiaries to demand payment from the trustee. In response to the Service's argument that annual exclusions should only be allowed for powers of withdrawal held by "primary beneficiaries," the tax court held that the *Crummey* case did not require a powerholder to have a vested present interest or a vested remainder interest in the trust corpus in order that gifts subject to the power qualify for the annual exclusion. The court stated that the legal ability to exercise their right of withdrawal, and not the likelihood that the beneficiaries would do so, was the test for determining whether a present interest was received. Moreover, the court held as irrelevant the decedent's tax-saving motives for giving the grandchildren withdrawal powers.

Richard W. Miller

Calendar of Seminars and Events

- October 3-4, 1991 (Sponsored by National Law Foundation) **Annual Fiduciary Tax Conference**, Hotel Pennsylvania, New York, New York, Telephone: (302) 656-4757
- October 3-5, 1991 (Sponsored by ALI-ABA) **Creative Tax Planning for Real Estate Transactions in a Depressed Market**, Washington Vista, Washington, DC, Telephone: 1-800-CLE-NEWS
- October 7-8, 1991 (Sponsored by National Law Foundation) **The Comprehensive Estate, Gift and Trust Workshop**, Omni Inner Harbor Hotel, Baltimore, Maryland, Telephone: (302) 656-4757
- October 9-12, 1991 (Sponsored by Southern California Tax & Estate Planning) **11th Annual Southern California Tax & Estate Planning Forum**, Meridien Hotel, San Diego, California, Telephone: (619) 696-6773
- October 16-18, 1991 (Sponsored by ALI-ABA) **Third Annual Uses of Insurance in Estate and Tax Planning**, The Omni Hotel, Charleston, South Carolina, Telephone: 1-800-CLE-NEWS
- October 17-18, 1991 (Sponsored by Washington State Bar - Estate Planning Council of Seattle) **Estate Planning 1991**, Washington State Convention & Trade Center, Seattle, Washington, Telephone: (206) 448-0433
- October 17-18, 1991 (Sponsored by Practising Law Institute) **22nd Annual Estate Planning Institute**, Omni International Hotel, Orlando, Florida, (Also in New York City, October 24-25, 1991; and San Francisco, November 7-8, 1991), Telephone: (212) 765-5700
- October 24-25, 1991 (Sponsored by the ABA) **Health and Welfare Benefit Plans**, Washington Hilton, Washington, DC, Telephone: (312) 988-6214
- October 27-November 1, 1991 (Sponsored by Hawaii Tax Institute - Chaminade University of Honolulu) **28th Annual Hawaii Tax Institute** (Includes Estate Planning 10/27-10/28), Hawaiian Regent Hotel, Waikiki, Oahu, Hawaii, Telephone: (808) 946-2966
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- November 18-22, 1991 (Sponsored by American Law Institute) **Planning Techniques for Large Estates**, Grand Hyatt, San Francisco, California, Telephone: 1-800-CLE-NEWS
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- January 6-10, 1992 (Sponsored by University of Miami, Law Center) **26th Annual Institute of Estate Planning**, Fontainebleau Hilton Resort & Spa, Miami Beach, Florida, Telephone: (305) 284-4762
- January 27-30, 1992 (Sponsored by University of Southern California) **Institute on Federal Taxation**, Beverly Hills Hilton, California, Telephone: (213) 740-2646
- January 22-24, 1992 (Sponsored by ALI-ABA) **Basic Estate and Gift Taxation and Planning**, New Orleans, Louisiana, Telephone: 1-800-CLE-NEWS



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