newsletter

Oregon Estate Planning and Administration Section Newsletter

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Alternatives To Private Foundations

The traditional goal of a wealthy philanthropist has been to endow his or her own family foundation, but the paperwork and legal restrictions required for maintaining a private foundation can be overwhelming. A client contemplating the creation of a private foundation should investigate the following alternatives: supporting organizations, advised funds at community foundations, and pass-through foundations. These vehicles for giving may permit a larger income tax deduction and will avoid the restrictions imposed on private foundations.

Private Foundations

The Internal Revenue Code defines a private foundation as any organization (trust or corporation) that qualifies as a tax-exempt charity under IRC § 501(c)(3), unless it also qualifies as a "public charity" under IRC § 509. All IRC § 501(c)(3) organizations must be organized and operated exclusively for charitable, religious, scientific, or educational purposes. The Code also restricts their private inurement, influencing legislation, and political lobbying.

The primary advantages of a private foundation are the following: (1) the donor receives an immediate income tax charitable deduction, regardless of when the gift to the foundation is distributed to other charities; (2) a private foundation provides a common charitable fund to which all family members may contribute; and (3) the creator of the private foundation and his or her family members control the use of the money.

The primary disadvantages of private foundations are the following: (1) a 2 percent tax on the foundation's net investment income; (2) a prohibition on acts of self dealing between the foundation and donors, foundation managers and family members of donors; (3) a requirement that the foundation distribute each year an amount equal to at least 5 percent of its assets; (4) a restriction on the amount of shares or partnership interests in a particular business that the foundation may hold (excess business holdings); (5) a prohibition on investments that jeopardize the foundation's charitable purposes, generally by being too risky; and (6) restrictions on expenditures to influence legislation and on making grants to individuals and foreign charities (taxable expenditures). The prohibitions and restrictions are enforced by penalty taxes ranging from 2.5 percent to 200 percent.

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The Code limits donors' charitable deductions for contributions to private foundations. Gifts of cash or nonappreciated property are deductible at full value, but only up to 30 percent of the donor's adjusted gross income each year (rather than the 50 percent allowed for gifts to public charities). The deduction for appreciated property is limited to the donor's basis in the property and only up to 20 percent of the donor's adjusted gross income each year (rather than fair market value and 30 percent of adjusted gross income for donations to public charities). In each case there is a five year carry forward for any amount in excess of the annual limitations.

Supporting Organizations

A "supporting organization," defined in IRC § 509(a)(3), qualifies for treatment as a public charity based upon its relationship with one or more public charities. A supporting organization must be operated to carry out the purposes of the publicly supported charity and must be operated, supervised, or controlled by or in connection with the supported organization. The board of directors or trustees of a supporting organization cannot be controlled by donors or their family members. Complicated IRS regulations are used to determine whether an entity qualifies as a supporting organization under IRC § 509(a)(3).

A supporting organization operates like a subsidiary to a nonprofit organization and can be organized in corporate or trust form. Supporting organizations are not subject to the regulations and penalty taxes imposed on private foundations. Gifts to supporting organizations are deductible to the same extent as gifts to public charities: 50 percent of the donor's adjusted gross income for gifts of cash and nonappreciated property and 30 percent of the donor's adjusted gross income for gift of appreciated property.

A donor could choose to create a supporting organization to support a public charity that the donor has personally supported in the past. Even though the donor and his or her family cannot control the board of directors or trustees, the donor can appoint board members who share the donor's philanthropic goals.

Advised Funds

Community foundations are collections of individual or "component" funds donated by many individuals. These funds are owned by the community foundation and are pooled for investment purposes, but grants can be issued under the individual donors' names. Oregon's largest community foundation is the Oregon Community Foundation, which manages assets in excess of $100 million. Most community foundations qualify as public charities.

An advised fund is created by an agreement between the donor and the community foundation. Under the agreement, the donor can require the foundation to request or solicit the donor's advice on grants from the fund. Because the charitable deduction is not available if the donor controls distribution of the funds, the community foundation manager is not required to follow the donor's suggestions. Usually, however, the foundation follows the donor's recommendations.

Advised funds are administered by the community foundation; the foundation makes investment decisions, fulfills tax reporting requirements, and handles grants to the charities. This assistance makes community foundation advised funds easy and inexpensive for the donor to set up and maintain. The time and expense of creating and managing a private foundation are saved, while gifts are deductible to the same extent as gifts to public charities.

Pass-Through Foundations

A pass-through foundation may work for a donor who wants to be involved in the giving process. All the money donated to a pass-through foundation is distributed to charities instead of being invested in an endowment. All contributions to the organization must be passed through to charities no later than two and a half months after the close of its taxable year. Pass-through foundations are subject to the excess holding and self-dealing restrictions that apply to private foundations, but the donor benefits from the larger tax deduction available for donations to public charities. Pass-through foundations must provide donors with records documenting the qualifying distributions. The qualifying distributions may not be made to an organization controlled directly or indirectly by the pass-through foundation, by a disqualified person, or by another private foundation.

Conclusion

If the prestige and control associated with endowing a private foundation are outweighed by the accompanying deduction and administrative restrictions, your philanthropically minded clients may achieve their giving goals through one of the alternatives to private foundations described in this article.

Eryn Forbes

Oregon Estate Recovery

I. Oregon Legislature Extends Medicaid Estate Recovery to Include Nonprobate Assets

The 1995 Oregon legislature amended ORS 414.105 to expand Medicaid estate recovery to an augmented estate consisting of the decedent's interest in "assets conveyed to a survivor, heir or assign of the decedent through joint tenancy, tenancy in common, survivorship, life estate, living trust or other similar arrangement." Or Laws 1995, ch 642, § 1. The Oregon legislature did not amend the claims process, leaving intact the current estate claims process as a precondition for expanded recovery. This article reviews the basics of Medicaid estate recovery and discusses the problems created by the expanded definition of the estate to which recovery applies.

II. Client Situations Triggering an Inquiry About Medicaid Estate Recovery

Probate Administration for Decedents

Medicaid estate recovery is an issue in probate administration if the decedent or the decedent's deceased spouse formerly received medical assistance. Decedents who needed nursing home help are likely to have received Medicaid to pay that bill. Medicaid recipients usually have only "exempt" assets at death: a home, automobile and personal property. In some cases, the former Medicaid recipient may have gone off public assistance because of receipt of an inheritance, personal injury award, or some other windfall prior to death.

In probate administration, the lawyer might ask if the decedent had ever been in a nursing or foster home, and if so, how that bill had been paid. Because Oregon continues to seek collection from surviving spouses' estates, the lawyer might ask whether a prior spouse had been in a nursing or foster home paid for by the state. The personal representative may not know if Medicare or Medicaid paid the bill, and the lawyer should inquire of the nursing home to clarify the source of payment for its bill.

Estate Planning for Clients Who Cannot Self-Insure for Long-Term Care or Who Have Disabled Members of the Family

Medicaid estate recovery is an issue in estate planning if the client or the spouse of the client might someday receive Medicaid assistance, and if the client wants to benefit an individual or charity at death rather than have all his or her assets used to pay back the state for medical assistance. No one document or planning technique will bullet-proof the client's plan to avoid Medicaid estate recovery. However, having certain tools available will permit the client more flexibility. The law as it changes will determine how the tools are used. The recommended tools are:

- financial powers of attorney, specifically:
  - declaring where care is to be provided
  - requiring spenddown for care (if desired)
  - permitting payment to family members for care
  - permitting transfers to or for spouses and disabled children (if desired)
  -permitting creation and funding of revocable and irrevocable trusts for self and others
  -permitting withdrawals and distribution of assets from trusts that might turn into traps for assets and pre-death distribution (if desired)
  - permitting gifts for tax planning or estate planning purposes (if desired)
  - permitting entry of a support order splitting income so that the bulk of income can be used to support the spouse remaining in the house
  - permitting entry of an order transferring assets to support a healthy spouse
- prenuptial agreements allocating risks of care costs and permitting the healthy spouse to save resources (perhaps joined with contracts to make wills irrevocable, to protect heirs of both spouses)
- long term care insurance

The clients will need to see their lawyer initially to get the proper tools in place, periodically to update the documents, and promptly when the first diagnosis of a possibly incapacitating disease is made.

Nonprobate Transfers at Death

The new expanded definition of estate creates the potential for state claims against those receiving property at the death of a Medicaid recipient, former Medicaid recipient, or decedent whose spouse was once a Medicaid recipient. The expanded estate includes assets conveyed to a survivor, heir, or assign of the decedent through joint tenancy, tenancy in common, survivorship, life estate, living trust, or other similar arrangement. ORS 414.105(5).

When assessing a possible probate administration case, the lawyer may be tempted to avoid probate in a one-house estate by purchasing a double-premium title policy. Unfortunately, the distributees take subject to possible probate claimants. The state of Oregon can file for probate on its own petition and seek to force reachable assets through probate. The author has examined one case in which the double-premium title policy contained an express promise by the distributees of the real property to pay any outstanding claims, and the state of Oregon, acting within a year of the decedent's death, threatened to initiate probate if its claim was not paid by the distributees.

Failing to cut off the estate recovery claim rights of the state in the probate administration can deprive those who receive property at death of important procedural and substantive protections. With the 1995 expansion of Medicaid estate recovery to nonprobate transfers, the lawyer might well advise a probate (even a forced small estate proceeding) to cut off the rights of claimants including the State.

III. Procedure for Expanded Estate Recovery

Where there is no probate estate, or statutory procedure permitting application by creditors directly to the successor trustee of a revocable living trust (as in Cal Probate Code §§ 19000-19403 (West Supp 1996) and RCW 11.18.200(2)), no fiduciary is appointed or available to administer assets passing outside probate.

The leading case on proceeding against nonprobate interests of a decedent in Oregon is *Johnson v. Commercial Bank*, 284 Or 675 (1978). In that case, a home care provider billed the decedents' revocable living trust, but was not paid. The bank trustee was nominated as personal representative in the pourover will, but never filed for probate as no assets passed outside the trust. The home care provider filed for appointment as personal representative, and then filed her claim against the estate. The court allowed the claim, and the personal representative then filed suit against the bank trustee.

The plaintiff argued that the revocable living trust was void as to the grantor's creditors. *See* former ORS 95.060. In Oregon, the personal representative of an insolvent estate (claims exceeding assets) may pursue transferred property if the pre-death transfer is void against creditors. *See* ORS 114.435.

If the state as claimant wishes to recover against an expanded estate, it must first present its claim against the probate estate and then demand that the personal representative pursue void or voidable transfers by the deceased Medicaid recipient.

"If trust assets are subject to a deceased grantor's debts, the creditor will generally be required to file a claim against the grantor's probate estate. . . ." *Creditor's Right and Spendthrift Clauses, Administering Trusts in Oregon*, ch 8.42 at 8-25 (OSB CLE 1995).

IV. Practical Tips in Handling Estate Administration

In probate administration, the statute requires the personal representative to look for possible claims, to send notice to possible and actual claimants, and to handle claims expeditiously and in an orderly fashion. ORS 115.001-325. The following are some practical suggestions in Medicaid estate recovery situations.

Who Can Recover?

The state has the right to recover, but the claims are handled through the Department of Human Resources, Senior and Disabled Services Division, Estate Administration Unit, PO Box 14021, Salem, Oregon 97309. Although the Oregon probate claims statute refers to the Adult and Family Services Division as the only preferred claimant, ORS 115.125(1)(h), no cases interpreting that anomaly have been litigated in Oregon.

Only the personal representative has the right to proceed against nonprobate assets in an insolvent estate. ORS 114.435.

Process for Recovery

If the state provided medical assistance to the decedent after age 55, then the attorney advising the prospective personal representative or a recipient of nonprobate property at the decedent's death should carefully consider whether a probate would provide protection. Just as the probate process is useful to cut off claims of creditors in a lawyer's or doctor's estate, the probate process will be useful in the Medicaid claim situation.

ORS 414.105(2) requires that the state establish its claim against an estate before proceeding to recover against an expanded estate. If the lawyer finds that the claim recovery should be denied because of the existence of a protected survivor or will be limited because of the nature of benefits provided, a probate of a small asset will be useful to raise the defenses.

ORS 414.105(2) declares that recovery may be made against the estate or from any recipient of property or other assets held by the individual at the time of death, including the estate of the surviving spouse. Federal law contains no such provision; direct actions outside of probate against recipients of property (including surviving spouses) are not contemplated. *See* 42 USCA § 1396p(b) (1992 & Supp 1995.) Yet we can anticipate that aggressive estate recovery against nonprobate assets will be attempted in Oregon. These attempts should be resisted.

> **Practice tip:** When a claim exists, do a regular probate to start the running of time limits. Deny the state's claim, giving reasons, or allow it and pay with the minimal estate assets. Wait four months, then close the estate. If the state later attempts recovery from recipients of nonprobate property, use the affirmative defense bar of the estate claim procedure and the statute of limitations.

Defenses to Recovery

1. Barrier to Recovery From Preferred Survivor

The claim can be "established against the estate" but cannot be recovered if the recipient left a surviving spouse, a child under 21 years or a disabled or blind child. The Oregon statute refers to possible recovery from "the estate of the surviving spouse" but such recovery is not permitted under Federal law. *See* Barrett, *What's Hot in Elder Law, Current Issues in Oregon Elder Law & Medicaid* (Prof. Educ. Systems, Inc. 1995); Barrett, *Estate Recovery of Medicaid Payments, Elder Law & Medicaid Planning Issues in Oregon* (Prof. Educ. Systems, Inc. 1993).

Federal law limits recovery from the estate to a time when the Medicaid recipient has no surviving spouse, no child under 21, and no blind or disabled child. Federal law provides:

> "Any adjustment or recovery under paragraph (1) may be made only after the death of the individual's surviving spouse, if any, and only at a time—"
>
> "(A) when he has no surviving child who is under age 21, or . . . is blind or disabled. . . ."
>
> 42 USCA § 1396p(b)(2) (Supp 1995).

Oregon law provides:

> "Claim for such medical assistance correctly paid to the individual may be established against the estate, but there shall be no adjustment or recovery thereof until the death of the surviving spouse, if any, and only at a time when the individual has no surviving child who is under 21 years of age or who is blind or permanently and totally disabled. ORS 414.105(2)."

Oregon's claim procedure contemplates two steps: (1) establishment of a claim and (2) recovery from the estate if the decedent left none of the defined survivors. When the decedent died leaving one of these survivors, the attorney should notify the Department of Human Resources, SDSD, Estate Administration Unit for the state of Oregon, try to get a letter from the state acknowledging that the state has no right to recover, and then close the estate as promptly as possible, referring to the text of the federal law in the final account. I have assigned out the right to some holdover delayed asset rather than keeping an estate open longer.

2. Statute of Limitations

A claim is barred from payment by an estate unless it is presented within the earlier of two years after the decedent's death or the applicable statute of limitations. ORS 115.005(4). The state is limited by the same probate claims procedure as other claimants. If the claim is timely filed and then denied by the personal representative, the state must proceed with a hearing or lawsuit to enforce its rights. Closing the estate cuts off the rights of claimants.

Limits on What Interests Are Subject to Recovery

The value of the transferred asset to be recovered against is the "extent and value of the Medicaid recipient's legal title," ORS 414.105(4), and is limited "to the extent of such interest" in the federal statute. 42 USCA § 1396p(b)(4)(B) (Supp 1995).

The entire value of an asset is not subject to recovery. Rather, recovery is limited to the interest of the Medicaid recipient at time of death. If the value of the decedent's interest is minimal or zero, so is the risk of recovery.

Oregon's 1995 amendments to ORS 414.105 attempt to shift the burden of proving the decedent's interest to the recipient of property, ORS 414.105(4), but the allegation of an interest and its value is part of the state's case in chief. The shifting burden should be resisted as an impermissible expansion of the state's right of recovery and unwarranted under both the common law and federal law.

The interest subject to recovery must be held by the Medicaid recipient at the time of death and must be conveyed at death to another. For example, the interest of the decedent at death in a life estate is zero, as the following excerpt illustrates:

> "Defendants cite a case where the settlor gave himself a life estate with remainder to specified persons and did not retain the power to revoke. We agree that creditors could not reach the remainder interests under such facts because such conveyances give the remaindermen present vested interest in the property that cannot be defeated by any act of the settlor. Such remainder interests are present gifts that are no more subject to the claims of creditors than are any other gifts." *Johnson* 284 Or at 682 (Footnote omitted).

Let us consider the sort of assets mentioned explicitly in the federal statute and copied in the amendments to ORS 414.105(2):

> Personal and real property conveyed to a survivor, heir or assign of the deceased individual through
>
> 1. Joint tenancy: abolished in Oregon as to real property
>
> 2. Tenancy in common: creates a probate asset
>
> 3. Survivorship: very broad; interest of decedent depends on contribution and law governing the particular form of holding

4. Life estate: no value at death; remainder reachable if void or voidable transfer, for example, power to control retained

5. Living trust: no value at death; remainder reachable if void or voidable transfer, for example, power to control retained

An irrevocable trust remainder, which is vested and limited to a determinate person, is not reachable by creditors of an estate. The irrevocable trust remainder interest is a transfer upon creation of the trust and is vested in fee. If the grantor cannot divest the interest, then it is not reachable. Annotation, *Nature of Remainder Created by Inter Vivos Trust Giving Settlor, Trustee, or Life Beneficiary Power to Exhaust Trust Fund or Otherwise Terminate Trust,* 61 ALR2d 477 (1958); Paulus, *Future Interests in Oregon*, 15 Will LJ 151 (1979); *Johnson* 284 Or 675.

A revocable living trust set up by others for the benefit of the disabled individual may be attacked. Such attacks will not be successful, however, because if the trust is revocable then the nondisabled grantor of the trust controls the trust, and the disabled beneficiary has no vested interest at all. I recommend against granting the disabled beneficiary a general power of appointment in any testamentary or living trusts for disabled individuals, to reduce the risk of the state's misunderstanding its reach in estate recovery matters.

6. Other similar arrangement: Perhaps TOD or POD accounts are contemplated, but these are available resources and would disqualify the beneficiary. If a Medicaid beneficiary had gone off assistance and then died with a POD account, the value of his interest at death would be subject to estate recovery. Same analysis as survivorship above.

Medical Assistance May Be Established in Claim

Oregon has elected to seek the broadest possible recovery for all medical assistance provided after the age of 55 years. No recovery is permitted for services provided before the recipient was 55 years of age. Oregon may recover for nursing facility services, foster home services, home care, medications and medical equipment.

Conclusion

When working on an estate plan, an attorney should consider whether Oregon (or any other state) may present a claim for recovery of the costs of medical assistance provided by the state. The attorney should help his or her clients understand the risk of exposure, and advise them of their choices under the law.

When handling probate and nonprobate administration, and when advising a fiduciary about the duty to find and notify claimants, an attorney should consider the state of Oregon's possible claim for medical assistance. If an estate recovery claim is filed, the attorney should determine its validity and handle administration in a straight forward manner, raising the defenses appropriate to the case. Estate recovery claims against nonprobate transfers will cause the greatest uncertainty. Because Oregon has not yet tried to recover against nonprobate transfers under the new law, the extent of the state's reach remains an unsettled issue. Attorneys should search for valid defenses and help keep Medicaid estate recovery within the bounds of the law.

Cynthia L. Barrett

From the Bench

Following in the wake of the enactment of sweeping revisions of the guardianship and conservatorship laws has been a flurry of seminars and articles summarizing and interpreting the new laws. As the pro tem probate judge in Marion County, I have watched with great interest the evolution and passage of SB 61 and the ensuing commentary. At the risk of overkill, I will address some of the nuances of the law that will affect how lawyers practice in this area.

The new law clarifies that the court must apply a clear-and convincing-evidence standard of proof in all guardianships and conservatorships. Or Laws 1995 ch 664, §§ 28(1), 33. This follows the requirement imposed by appellate courts in contested cases but highlights the requirement for uncontested cases. To meet this burden of proof (and to comply with other changes), the petitions should be very fact specific, explaining why the respondent meets the statutory requirement for protection and what result could occur if no protection is provided. In Marion County, we now review guardianship petitions at the time of filing; if a petition omits adequate factual allegations, we call the attorney to request an amended petition. (To assist the visitors, we also ask attorneys to provide telephone numbers for the people to be interviewed.)

The standard of proof issue dovetails into one of the law's far-reaching changes: The court visitor's ability to obtain information from medical professionals and care providers is now "subject to any law relating to confidentiality." Or Laws 1995 ch 664, § 16(3). If medical professionals and care providers refuse to provide information, the visitors will need to conduct more detailed interviews, possibly interview more people and write more detailed reports. The petitioner's lawyer may also need to

provide detailed affidavits to support the allegations in the petition in uncontested cases. In some cases, the visitor may lack enough information to make a recommendation and an independent medical examination will be required or the court will deny the petition. It may be most difficult for the petitioner to meet the burden of proof in psychiatric cases, because the visitors rely more on medical information in psychiatric cases than in cases involving incapacitated elderly people.

The clear application of the civil procedure rules in protective proceedings, 1995 Or Laws ch 664, § 6, creates new responsibilities for the petitioner's attorney. The civil procedure rules require the attorney to sign the petition. ORCP 17 A. The signature is certification that "to the best of the knowledge, information and belief of the [attorney] formed *after* reasonable inquiry [the petition] is well grounded in fact. . . ." Id. (emphasis added). I believe this has the effect of requiring the petitioner's attorney to investigate the facts in the petition beyond what the petitioner conveys to the attorney. The attorney and petitioner can be subject to sanctions if the petition is signed in violation of this rule. ORCP 17 C.

Another important but possibly overlooked provision is that the new law applies only to protective proceedings commenced on or after January 1, 1996. Or Laws 1995 ch 664, § 104. This means that chapter 126 will continue to apply to pre-1996 guardianships and conservatorships. This dual-statute arrangement will probably prove inconvenient and awkward but, as a practical matter, should not be very noticeable. One notable difference is that visitors for pre-1996 files will not be subject to the confidentiality restrictions. *Cf.* former ORS 126.103(4). For the convenience of the court, I would like pre-1996 guardians to file reports using the new guardian forms, but I cannot require that. Likewise, it would be preferable, but it is not required, for lawyers to apply the new notice and annual accounting provisions to pre-1996 files.

From my perspective, chapter 664 is a big improvement to the guardianship and conservatorship laws. It creates a more logical description of the process, provides more information to the court, and provides more protection for respondents and protected persons. As with any sweeping statutory change, some adjustments may be necessary, but, on the whole, I think the new statute will operate smoothly and effectively.

In closing, I encourage lawyers who encounter problems with cases in Marion County to call me or the Probate Commissioner, Brenda Myers, and we will attempt to answer questions and provide guidance in interpreting the new law.

Jennifer Bellinger Todd
Circuit Court Judge Pro Tem
Marion County

Oregon Department Of Revenue Clarifies Effect Of Legislation Eliminating Income Tax Releases

Oregon Laws 1995, chapter 453, amended ORS 116.113 and 316.387 to eliminate the requirement that a probate may not be closed without an income tax release from the Oregon department of revenue. Although releases are no longer required, the department of revenue has received a number of requests for such releases. By letter to the chair of the Estate Planning and Administration Section dated October 19, 1995, the department of justice, at the request of the department of revenue, has asked that the section inform its members that the department of revenue is not issuing releases and will refuse requests for releases. Probate practitioners are urged to familiarize themselves with the new law.

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CALENDAR OF SEMINARS AND EVENTS

- January 21-26, 1996 (Sponsored by National Law Foundation) **Caribbean Estate Planning Conference at Casa de Campo Resort, Dominican Republic**. Telephone (302) 656-4757.
- February 9, 1996 (Sponsored by Northwestern School of Law) **25th Annual Estate Planning Seminar**, Convention Center, Portland, Oregon. Telephone (503) 768-6629.
- February 11-14, 1996 (Sponsored by Argus Trade Shows) **7th Annual Conference on Estate Planning and Administration *and* Creating & Maintaining a Successful Estate Planning & Administration Practice**, The Ritz-Carlton, San Francisco, California. Telephone (404) 618-0499.
- February 15-17, 1996 (Sponsored by ALI-ABA) **Qualified Plans, PCs, and Welfare Benefits**, Red Lion La Posada, Scottsdale, Arizona. Telephone (800) CLE-NEWS.
- February 22-24, 1996 (Sponsored by ALI-ABA) **Advanced Estate Planning Techniques**, Grand Wailea Resort & Spa. Maui, Hawaii. Telephone (800) CLE-NEWS.
- March 20-22, 1996 (Sponsored by ALI-ABA) **Pension, Profit-Sharing Welfare, and other Compensation Plans**, Ritz-Carlton, San Francisco, California. Telephone (800) CLE-NEWS.
- April 15-16, 1996 (Sponsored by New York University) **Trusts and Estates**, New York, New York. Telephone (212) 790-1320.
- April 22-26, 1996 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, The Plaza, New York, New York. Telephone (800) CLE-NEWS.
- May 2-3, 1996 (Sponsored by ALI-ABA) **Charitable Giving Techniques,** San Francisco, California. Telephone (800) CLE-NEWS.
- May 16-17, 1996 (Sponsored by American Bar Association) **Real Property, Probate and Trust Seminar**, San Diego, California. Telephone (312) 988-5591.
- May 23, 1996 (Sponsored by Oregon State Bar) **Elder Law Seminar**, Oregon Convention Center, Portland, Oregon. Telephone (503) 620-0222.
- June 3-4, 1996 (Sponsored by New York University) **Trusts and Estates**, San Francisco, California. Telephone (212) 790-1320.
- June 5-7, 1996 (Sponsored by ALI-ABA) **Basic Estate and Gift Taxation and Planning**, Omni Charleston Place, Charleston, South Carolina. Telephone (800) CLE-NEWS.
- June 7, 1996 (Sponsored by Willamette University Law School) **15th Annual Tax Conference**, Willamette University Law School, Oregon. Telephone (503) 370-5402.

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newsletter

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When in Doubt, Let the Court Decide: How To Protect Fiduciaries from Liability by Advance Approval from the Courts

Personal representatives and trustees are fiduciaries. One of their primary duties is to manage property on behalf of the beneficiaries of the estate or trust. In carrying out this duty, the fiduciary is given authority under state law. ORS 114.265, .305, .325 give statutory authority to a personal representative and ORS 128.009 grants such authority to a trustee. Often, the terms of the will or the trust agreement give the fiduciary additional authority.

Whether provided by statute or by governing instrument, this authority simply gives the fiduciary the power to perform an act. It does not protect the fiduciary against liability for possible breach of fiduciary duty by the performance of that act. The purpose of this article is to review specific statutory provisions that are available to personal representatives and trustees, permitting them to minimize the potential liability inherent in the exercise of authority by asking the court for guidance and approval in advance of any decision.

Example of Potential Liability.

In the course of administering an estate or trust, the fiduciary will be faced with many decisions. One decision that often arises is whether property should be sold. ORS 114.325 gives a personal representative the authority to sell estate property, and ORS 128.009(3)(g) confers a similar power upon a trustee. This power to sell property, however, is subject to restrictions that do not appear in the statutes. In selling property, the fiduciary is obligated to sell at fair market value. If there is no readily ascertainable price for the property to be sold, fair market value is uncertain. A sale of the property at less than fair market value will result in a loss to the beneficiaries of the estate or trust for which the fiduciary may be liable. ORS 114.395; *Wittick v. Miles*, 274 Or 1, 545 P2d 121 (1976). In *Moser v. Van Winkle*, 103 Or App 398, 787 P2d 1063 (1990), the court held a personal representative liable for attorney fees and costs resulting from a breach of fiduciary duty. The same result could occur with respect to a trustee under ORS 128.155. Even if the fiduciary has a buyer willing to pay fair market value for the property, a sale may breach the fiduciary's duty if the sale is not in the best interests of the estate or trust. *See Helgesson v. Frank,* 17 Or App 133, 521 P2d 16 (1974).

Statutory Provisions Available to Personal Representatives.

The Oregon Probate Code gives a personal representative the authority to apply to the probate court for advance approval of a desired action. ORS 114.275. To

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receive such Approval the personal representative must file a petition for authority with the court as provided in ORS 111.205. Upon filing the petition, the personal representative should serve notice of the petition on all interested parties and give them at least 14 days to file objections with the court. ORS 111.215. If an interested party objects to the petition, the court may set a hearing to decide the issue. The hearing would allow all parties to present their arguments concerning the proposed act.

If the personal representative is requesting authority to sell property, the petition and resulting court order should specifically address the adequacy of the proposed purchase price, whether the sale would be in the best interest of the estate, and any other relevant issue such as the tax consequences of the sale. The court order will have the same finality as an order from a court of record with general jurisdiction. ORS 111.095(1).

If the court approves the proposed action and the personal representative proceeds according to the court order, no person who was a party to the petition for authority would be able to challenge the action at a later date, provided all material facts were disclosed. If the court does not approve the request for authority, the personal representative will have similar protection for not taking the proposed action. This procedure ensures that all interested parties have advance notice of the proposed action and the opportunity to object. If the personal representative acts without using this procedure, interested parties will have the opportunity to object when the action is reported in the fiduciary's accounting.

Statutory Provisions Available to Trustees.

ORS 128.135(2)(c) permits the trustee of a trust to petition the circuit court in any county where trust assets are located or where the trustee resides, for authority, approval, or instructions on any matter concerning the administration of the trust. Subsection (3) of that statute further provides that the procedure involving the petition shall be the same as a petition to the probate court under ORS 111.205 to 111.235. Advance notice of the petition must be given to all trust beneficiaries. ORS 128.135(6) provides that the order of the court is final, conclusive, and binding on all trust beneficiaries notified of the proceeding, subject only to their right of appeal. A trustee has the same reasons to follow this procedure as does the personal representative of a decedent's estate. It allows the propriety of the act to be determined in advance and thereby significantly reduces the trustee's potential liability to the trust beneficiaries. The case of *Masters v. Bissett*, 101 Or App 163, 790 P2d 16 (1990), discusses the trustee's right to recover the costs of the petition and subsequent court hearing.

Conclusion.

Personal representatives and trustees are fiduciaries. Although they have the clear authority to perform certain acts, that authority does not protect them from liability resulting from the improper exercise of that authority. In such cases, Oregon courts have held the fiduciary liable for the resulting damages to the beneficiaries, including their costs and attorney fees. If a personal representative or a trustee is uncertain as to the propriety of a proposed act or feels that an interested party may object, it would be wise to petition the court for authority to carry out the act. Prior to the court acting on the petition, all interested parties will receive notice and the opportunity to object. By following this procedure, the fiduciary's potential liability for breach of fiduciary duty will be significantly reduced.

Daniel C. Re

Estate Distributions To Foreign Beneficiaries

This Article addresses a few of the issues that need to be considered in making distributions from an Oregon estate to a nonresident alien beneficiary. This Article does not address issues related to distributions to non-citizen spouses of United States citizens. Absent the use of specific planning tools such as a qualified domestic trust, distributions to non-citizen spouses are ineligible for the marital estate tax deduction.

Notice. ORS 116.093 provides that upon the conclusion of a probate, the personal representative must file a final account and a petition for decree of distribution, and give notice to all heirs or devisees, unpaid creditors, and any other person known to the personal representative "to have or to claim an interest in the estate being distributed." ORS 116.093(1)(d). The Oregon Court of Appeals has held that a personal representative must provide notice of the closure of an estate pursuant to ORS 116.093 or the order closing the estate will be void as to persons who were entitled to notice of the closing and did not receive notice. *Waybrant v. Bernstein*, 75 Or App 550, 706 P2d 1002 (1985); *see also Lawver v. Beesley*, 86 Or App 711, 740 P2d 1215, *rev den, 304 Or 279, 744 P2d 1003 (1987) (stating that proper notice is a prerequisite to the entry of a valid decree of distribution).*

Nonresident aliens are entitled to due process protection under the fourteenth amendment of the United States Constitution. Therefore, when providing notice of the closing of an estate to a nonresident alien beneficiary, it is important to provide a notice period that will allow the beneficiary to object in a timely manner to the closing of the estate. ORS 116.093 requires that the personal representative provide at least 20 days from the date of mailing for interested persons to file objections to the decree of distribution. Depending upon the circumstances, a personal representative should consider giving a nonresident alien beneficiary more than 20 days to object to a decree of distri-

bution. As a general rule, all notices to nonresident alien beneficiaries should be sent by registered mail so that there is no issue regarding the date of mailing. When a personal representative cannot with reasonable effort locate a nonresident alien beneficiary, the personal representative should consider petitioning the probate court pursuant to ORS 114.275 for instructions on how to proceed with the notice requirements.

Distribution. Before distributing assets from an estate to a nonresident alien beneficiary, the personal representative should check the currency exchange laws or other applicable restrictions on transactions with residents of the particular foreign country. If possible, the personal representative should obtain detailed instructions from the nonresident alien beneficiary as to how particular assets should be transferred to the beneficiary.

Many foreign countries do not tax distributions from a foreign estate, so long as the assets distributed have no relation to the foreign country, and the decedent was not a resident or a citizen of the foreign country. Other countries, however, tax distributions to beneficiaries domiciled in their country regardless of the source of the devise or inheritance. Although it is the nonresident alien beneficiary's responsibility to pay any inheritance, income, or other tax due and to file all required tax returns, the personal representative should provide the beneficiary with documentation to assist the beneficiary with any required filings.

Fiduciary Income Tax Issues. If an estate has a nonresident alien beneficiary, the personal representative is required to file a Form 1041 regardless of whether the estate has gross annual income in excess of $600. IRC § 6012(a)(5). The taxation of income earned by an estate and distributed to a nonresident alien beneficiary depends on the characterization of the distributed income. Income subject to taxation in the hands of the beneficiary retains the same character that it had in the hands of the estate. IRC § 663(b).

The characterization of income held by an estate generally depends on whether the income is "effectively connected" with the conduct of a United States trade or business. In general, if an estate's income is effectively connected with the conduct of a United States trade or business, the income will be taxable to a nonresident alien in accordance with the regular federal income tax rates. IRC § 871(b). If an estate's income is not effectively connected with the conduct of a United States trade or business, gross income distributed to a nonresident alien beneficiary from the estate will be taxable at a flat 30% tax rate and is subject to withholding at the source of the income. IRC § 871(a); IRC § 1441. For more detail on this issue, including an extensive discussion on the characterization of distributions, see M. Read Moore, *Taxation of Trust and Estate Income Distributed to Nonresident Alien Beneficiaries*, Oregon State Bar Taxation Section Newsletter, Vol 1, No. 1 (Aug 1995).

Penny Serrurier

New Rules Apply To Oregon Income Tax Issues In Estate Administration

In Chapter 453 of 1995 Oregon Laws, the Oregon Legislature made some significant changes in the area of income tax issues in estate administration. In general, the changes bring Oregon in line with federal procedures for limiting liability for income taxes owed by estates. Under the new Oregon statutes, final probate accountings must now contain a statement that all required tax returns have been filed. Oregon law no longer requires that an Oregon income tax release be obtained and filed before a probate court can authorize final distribution of assets. A personal representative is now allowed to elect a prompt audit of Oregon income tax returns of the fiduciary and the decedent, and the personal representative may seek exoneration from personal liability for the decedent's returns. These changes are applicable to estates for which an income tax release has not been requested as of September 9, 1995.

Final accounting — statement as to filing of returns.

The act amended ORS 116.083(3) to include a requirement that final accounts must contain a recital that all required tax returns have been filed. That subsection has always required final accounts to include a statement that all Oregon income, inheritance, and personal property taxes have been paid, or secured by bond. This requirement is still present.

Income tax releases / election for final determination.

The act also amended ORS 116.113 and 316.387 to eliminate the requirement that probate cannot be closed without an income tax release from the Department of Revenue. In fact, the ODR has now stated that it will no longer issue income tax releases in probated estates, even to those who specifically request a release.

ORS 316.387 now provides a new procedure for cutting off potential income tax liabilities. If a fiduciary files an election for a final tax determination, the Department of Revenue may issue a deficiency notice no later than 18 months after receipt of the election. The Department of Revenue has issued a new form to be used for the purpose of making this election, Form 150-101-151 - Election for Final Tax Determination for Income Taxes Relating to a Probated Estate. The election applies only to individual and fiduciary income tax returns filed "during the period of administration;" returns filed by the decedent during the

decedent's lifetime do not receive the benefit of the shortened period. The election applies both to the decedent's individual returns and to the fiduciary returns of an estate or trust. Although the form refers only to estates, the statute refers to both personal representatives and trustees. The Department of Revenue is currently revising the form so that it may be used by trustees as well as personal representatives. The form recites that copies of all relevant returns should be attached to the form, in addition to being listed on the form. If the new form is filed, no reply will be sent by the ODR.

If the election is filed, any deficiency notice issued after 18 months is invalid, with the following exceptions:

1. Omission of 25% or more of income, in which case a deficiency notice may be issued within five years after the return was filed;
2. A false or fraudulent return, or no return, was filed, in which case no limitations period applies; and
3. If a federal change is made, a deficiency notice can be issued within one year after the ODR is notified (by the IRS or by the taxpayer) of the federal change. The one-year period does not shorten any of the longer periods described above.

The amendments expand transferee liability by eliminating the cut-off previously provided by a release, since releases will no longer be issued. However, it does appear that transferee liability will be cut off, along with fiduciary liability, after the 18-month period has expired. In other words, when the election is filed for particular returns, both fiduciary and transferee liability will end after 18 months (with the exceptions noted above). For returns for which no election was made, however, both fiduciary and transferee liability will continue for the normal limitations period (generally three years for fiduciary liability and one year thereafter for transferee liability). Under old law, both fiduciary and transferee liability could be cut off by obtaining a release, although the beneficiaries continued to be liable for the pass-through of the income tax liability in the final year.

3. Request for release from personal liability.

Finally, the act permits a personal representative to request a release from personal liability for the decedent's individual returns, but not for fiduciary income tax liability. The request must be made in writing. The Department of Revenue is drafting a new form for making this request. Until the form is available, the personal representative or trustee may apply for discharge by means of a letter. If no notice of deficiency is received within nine months after making the request, the fiduciary is relieved of any liability, except to the extent assets are still in the hands of the fiduciary. Although this release does not affect transferee liability, the request is still beneficial to corporate fiduciaries and other non-beneficiary fiduciaries since they will have no liability after nine months (assuming they have not retained any assets).

If we assume that these new Oregon procedures will be interpreted in accordance with the similar federal law, the shortened time periods will not limit the joint and several liability of the surviving spouse for any returns filed jointly with the decedent. This liability would continue to exist as to the surviving spouse for the normal limitations period.

By the enactment of these new statutes, Oregon appears to have adopted procedures similar to the federal procedures for assessing income tax in the case of decedents' estates. Under IRC §6905, a fiduciary can request a release from personal liability for the decedent's individual returns nine months after filing a Form 5495. Under IRC §6501(d), a fiduciary can request a prompt audit of the decedent's individual returns and fiduciary returns by filing a Form 4810; if an assessment is not made within 18 months, no further assessments are permitted (with some exceptions).

Since the shortened period for assessment of Oregon tax does not apply if a federal adjustment is made, practitioners will want to consider filing both the Oregon election and the federal election. However, the filing of either the state or federal elections may prompt an audit, perhaps where one might not otherwise have occurred. If the ODR or the IRS is unable to complete its audit of the returns within the 18-month period, it may request the fiduciary to withdraw the request or it might issue a deficiency notice for the maximum amount of tax that could conceivably be due. Thus, in making a decision on whether or not to file the state or federal request, the personal representative must weigh the possibility of increasing the chances for an audit against the benefits of cutting the limitations period by up to one-half and exonerating the personal representative within nine months. Practitioners should review the individual tax situation of the decedent and the estate and fully advise the personal representative of the perceived risks and implications of filing the requests.

Perhaps the most significant effect of these new rules for the personal representative is that the risk of unpaid taxes can no longer be eliminated by a release. Personal liability for some taxes can be eliminated after nine months, and others will be released after an 18-month waiting period, but it will no longer be possible to close an estate or terminate a trust without some Oregon income tax liability remaining a possibility. At the time of final distributions, and possibly upon partial distributions, the personal representative may wish to obtain an indemnification from the distributees concerning any unpaid income taxes, perhaps as part of the distribution receipts.

Philip N. Jones
Peter J. Duffy

WHAT'S NEW

ORS Chapter 14 Effective Date

The Legislature, in a 1996 Special Session, passed SB 1165 to clarify the application of the new guardianship and conservatorship statutes:

> "Notwithstanding the repeal of statutory provisions by section 105, chapter 664, Oregon Laws 1995, any guardianship, conservatorship or other protective proceeding commenced under the provisions of ORS chapter 126 (1993 Edition) that is pending on the effective date of chapter 664, Oregon Laws 1995, shall continue to be governed by the laws in effect immediately before the effective date of chapter 664, Oregon Law 1995."

***McNeeley v. Hiatt*, 138 Or App 434 (1995)**

In *McNeeley*, the Court of Appeals held that a court cannot order a fiduciary to pay a plaintiff's attorney fees personally unless the fiduciary is named personally in the lawsuit.

Plaintiffs were the grandchildren of the decedent, Dollie Crockett. Dollie Crockett and her husband, Zahnie Crockett, owned a large amount of property in Curry County (the "Ranch"). In 1979, Dollie and her husband executed wills and a revocable living trust. Shortly after executing the documents, Zahnie Crockett died. Under the terms of the will and the trust, one-half of Zahnie's interest in the Ranch passed to Dollie directly, and the other half passed to a trust for the benefit of Dollie and their children (the "Zahnie Crockett Trust"). One child, Eva Hiatt ("Hiatt"), was named trustee of the Zahnie Crockett Trust. The terms of the Zahnie Crockett Trust provided that upon Dollie's death, the trust was to be distributed to Dollie's surviving children and to Plaintiffs, who were the surviving children of a deceased child of Dollie's.

In 1984, Hiatt "arranged" to have Dollie's will revised so that Dollie's interest in the Ranch would be distributed to her three surviving children, disinheriting Plaintiffs. The lawyer who drafted the 1984 will saw Dollie only at the will signing. Eleven days after the will was signed, Hiatt sold the Zahnie Crockett Trust's 25 percent interest in the Ranch to Dollie, effectively cutting Plaintiffs out of any interest in the Ranch.

Dollie died in November 1991 and Hiatt filed a petition to probate the 1984 will. Plaintiffs filed a timely will contest, naming Hiatt in her capacity as personal representative of the estate. Plaintiffs later amended their complaint, adding Hiatt in her capacity as trustee of the Zahnie Crockett Trust and alleging breach of fiduciary duty for the sale of the Ranch. Plaintiffs alleged under each claim for relief in the amended complaint that they were "equitably entitled to their attorney fees." Plaintiffs then filed an objection to Hiatt's Petition for Approval of Final Account and Distribution of Trust. In their objection, Plaintiffs requested costs and attorney fees, but did not cite specific authority for recovering the fees.

The trial court consolidated the three actions and found that the 1984 will was the product of undue influence. The court also held that Hiatt had breached her fiduciary duty as Trustee by selling the Trust's interest in the Ranch without obtaining a sufficient valuation and without advising the beneficiaries of the sale. The court removed Hiatt as personal representative and trustee, ordered the sale of the Ranch from the trust rescinded, and ordered that Hiatt pay Plaintiffs their attorney fees.

The Court of Appeals reviewed *de novo* the trial court's finding of undue influence regarding the will. In affirming the trial court decision, the Court stated that "the evidence demonstrates nearly all of the factors that are to be considered in determining whether undue influence has occurred." The Court went on to note that "the fact that Dollie Crockett appeared fit and active and expressed a desire to follow the advice of Hiatt does not disprove that Hiatt exercised undue influence in the process." The Court also affirmed the trial court's finding that Hiatt had breached her fiduciary duty in selling the Ranch without any expected benefit to the Zahnie Crockett Trust or its beneficiaries.

On the attorney fee issue, the Court applied ORCP 68(2)(a) which states in part that "[a] party seeking attorney fees shall allege the facts, statute, or rule which provides a basis for the award of such fees in a pleading filed by that party. * * * No attorney fees shall be awarded unless a right to recover such fees is alleged as provided in this subsection." The Court held that Plaintiffs did not allege a specific "fact, statute or rule" to provide a basis for recovering fees in the will contest action, stating the fact that "the action ultimately was consolidated with others in which there were allegations as to the basis for an award of attorney fees does not cure the problem."

Hiatt also argued that Plaintiffs were not entitled to fees on the action for a breach of fiduciary duty and on the

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petition for a final accounting, as the request for fees was "insufficiently detailed." The court dismissed this argument, but held that the trial court erred in ordering Hiatt to pay the attorney fees *personally* rather than out of trust assets as Hiatt was not named personally as a party to the action.

Penny H. Serrurier

***In re Altstatt,* 321 Or 324 (1995)**

The Supreme Court suspended Attorney from the practice of law for one year, finding violations of the disciplinary rules against (1) accepting employment where the lawyer's judgment will be affected by his or her own interests, (2) collecting illegal fees, and (3) engaging in conduct prejudicial to the administration of justice.

When Client died October 4, 1988, he owned a note payable from Attorney, bearing interest at 10% and maturing August 31, 1989. Client's will, prepared by Attorney, named two nieces as personal representatives. Attorney told the nieces at their initial meeting regarding the estate that "it would be hard for him owing money to the estate to also be lawyer, but there was no reason why he could not." He stated that there was no reason why he could not pay the note, because it was not due for ten months. He also told the nieces that they could consult with another lawyer before hiring him. The nieces hired Attorney without consulting another lawyer.

Client's will was admitted to probate October 12, 1988. The next day, Attorney requested $12,500 in fees from the personal representatives, but submitted no billing to them or petition for payment of fees to the court. The personal representatives complied with Attorney's request. Two months later, $15,000 in fees were likewise requested and paid. By July of 1989, four similar requests for fees were made and paid, and the fees for nine months' administration had totalled $59,000.

Two months before the promissory note came due, Attorney asked the personal representatives to extend the due date. He did not advise them of the continued conflict nor did he advise them to seek independent counsel on the issue. They agreed verbally to extend the due date indefinitely as long as all principal and accrued interest was paid before the estate closed.

At a show cause hearing after the first accounting was filed, the probate court asked Attorney about his debt to the estate and the fees he had been paid without court order. Attorney responded that the personal representatives had extended the note and that the will provided for "periodic payment of legal and accounting fees during the course of administration." As of a second hearing in September 1990, Attorney had made no payments on the note and had not reimbursed the estate for the fees taken.

By February 1991, Attorney had made no payments on the note, but had paid $2,200 from his own funds to the IRS on behalf of the estate. The probate court reported his conduct to the Bar and issued an Order prohibiting the personal representatives from spending estate funds without court approval.

By July 1992, when the disciplinary proceeding began, Attorney owed $33,500 on the note, had not petitioned for approval of the fees he had been paid, and still represented the personal representatives.

The Supreme Court found that Attorney violated DR 5-101(A), which requires consent after full disclosure in cases where the lawyer's representation of the client may reasonably be affected by the lawyer's own financial interests. DR 10-101(B) requires the consent to be confirmed in writing and to include a recommendation that the client seek independent counsel as to whether to consent. Attorney was found to have violated these rules twice: upon undertaking representation of an estate that was his creditor and upon continuing to represent the estate when he requested the extension.

The Court also found that Attorney illegally accepted fees in violation of DR 2-106(A). To be illegal, the acceptance of the fee need not be criminal, but need only violate a statute. ORS 116.183(1) states that "[a] partial award of [attorney] fees may be allowed prior to settlement of the final account upon petition, showing that the final account reasonably cannot be filed at that time, and upon notice as directed by the court." The Court noted that prior cases had put lawyers on notice that it was improper to accept attorney fees from estate assets without prior court order. *In re Weidner*, 320 Or 336, 883 P2d 1293 (1994), *In re Devers,* 317 Or 261, 855 P2d 617 (1993), *In re Phelps,* 306 Or 508, 760 P2d 1331 (1988), *In re Coe,* 302 Or 553, 731 P2d 1028 (1981), *In re Snyder,* 276 Or 897, 559 P2d 1273 (1976), Oregon Formal Ethics Opinion No. 1991-63.

Attorney was also found to be in violation of DR 1-102(A)(4), which prohibits lawyers from engaging in conduct that is prejudicial to the administration of justice. *In re Haws,* 310 Or 741, 801 P2d 818 (1990), had held that if, during a judicial proceeding, a lawyer's conduct causes or may cause harm to the substantive interest of a party to the proceeding, the conduct is prejudicial to the administration of justice. Attorney's failure to apply to the court for an award of attorney fees deprived the estate beneficiaries of the notice of an attorney fee application that is required by UTCR 9.090(4).

In suspending Attorney from the practice of law for one year, the court considered the following: (1) his misconduct was intentional, (2) he violated disciplinary rules, a uniform trial court rule and a statute, (3) he had no prior disciplinary record, (4) he was untruthful to the probate court, the bar and the trial panel about the facts of the case, (5) his conduct evidenced a selfish motive and indifference to making restitution, and (6) he had substantial probate experience.

Donna M. Muehleck

***Worthen v. Lumbermen's Underwriting Alliance, Inc.* 137 Or App 368, 904 P2d 1088 (1995)**

Decedent died in a logging truck accident in the course of his employment with an insured of Lumbermen's Underwriting Alliance, Inc., Defendant. Decedent's surviving spouse, Plaintiff, filed a workers' compensation claim that was accepted by Defendant. Plaintiff was appointed personal representative of Decedent's estate, and, on behalf of herself and the Decedent's three surviving children, filed a wrongful death action against the third parties who allegedly caused Decedent's death. The action resulted in a pre-trial settlement in the amount of $57,343.64.

A dispute arose between Plaintiff and Defendant over the distribution of the recovery obtained in the wrongful death action. Both parties petitioned the Workers' Compensation Board for resolution of their dispute. The Board issued a Third Party Distribution Order in which it determined that Defendant was entitled to a share of the settlement proceeds.

After the Board issued its Order, Plaintiff filed a motion in the probate court requesting distribution of the recovery from the wrongful death action. Applying ORS 30.030, the probate court ordered that the entire recovery be allocated to pay the costs, expenses and fees incurred in prosecuting the wrongful death claim. These costs, expenses and fees far exceeded the amount of the total recovery. As a result, there were no funds remaining to distribute to Defendant or to Decedent's beneficiaries, including Plaintiff.

On appeal, Defendant challenged the probate court's distribution of the wrongful death recovery, arguing that the court lacked statutory authority to abrogate the Workers' Compensation Board's award of a share of the settlement proceeds to Defendant. Defendant argued that because the wrongful death claim was brought by a workers' compensation claimant as a third-party action, the court must distribute the recovery in a manner consistent with the Board's Third-Party Distribution Order.

The Court of Appeals disagreed. The Court of Appeals examined two statutes in arriving at its decision: ORS 30.030 and ORS 656.593. ORS 30.030 directs the personal representative to distribute the damages obtained from a settlement or judgment in a wrongful death action in a specified manner. ORS 656.593 determines, inter alia, how the damages obtained by a workers' compensation claimant in a third-party action are to be allocated between the claimant and the paying agency that has been granted a lien against the cause of action.

The issue before the Court was which of the two statutes is to be applied first. The Court pointed out that a wrongful death action that is brought as a third-party action by or on behalf of a workers' compensation claimant is not necessarily exclusive to that claimant. The action may also involve dependents of the decedent who do not qualify as workers' compensation beneficiaries. In such an instance the Court had previously held that, although ORS 656.580(2) grants the paying agency a lien against the cause of action, the lien attaches only to that portion of the recovery distributed to the workers' compensation claimant, not to the total amount obtained in the cause of action.

Thus, the Court held that where wrongful death beneficiaries consist of both workers' compensation claimants and non-claimants, recovery first must be allocated among the wrongful death beneficiaries pursuant to ORS 30.030. Once the claimant, standing as a wrongful death beneficiary, receives his or her portion of the recovery, ORS 656.593 dictates how much of that claimant's share will be distributed to the paying agency. ORS 30.030(2) states, however, that before a claimant receives his or her portion of the recovery, the recovery must first be allocated to paying costs, fees and expenses incurred in pursuing the wrongful death claim.

In *Worthen,* Defendant could only be reimbursed if Plaintiff received a part of the wrongful death settlement. Because the costs, fees and expenses exceeded the amount of the total recovery, none of the wrongful death beneficiaries, including Plaintiff, received any part of the settlement or damages. Thus, Defendant's lien was effectively extinguished.

In concluding its opinion, the Court clarified its holding in *Liberty Northwest Ins. Corp. v. Golden,* 116 Or App 64, 840 P2d 1362 (1992). In *Golden*, the Court allowed the paying agency's lien to attach to the entire amount of the recovery distributed to the claimants pursuant to ORS 656.593 without first allocating the recovery pursuant to ORS 30.030. The Court distinguished *Golden* from *Worthen* because the third-party wrongful death action in *Golden* involved workers' compensation claimants exclusively.

Lisa N. Bertalan

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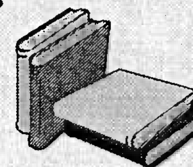

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- May 23, 1996 (Sponsored by Oregon State Bar) **Elder Law Seminar**, Oregon Convention Center, Portland, Oregon. Telephone (503) 620-0222.
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- June 5-7, 1996 (Sponsored by ALI-ABA) **Basic Estate and Gift Taxation and Planning**, Omni Charleston Place, Charleston, South Carolina. Telephone (800) CLE-NEWS.
- June 13-14, 1996 (Sponsored by ALI-ABA) **Conference on Sophisticated Pension and Welfare Plan and Compensation Issues**, Jackson Hole, Wyoming. Telephone (800) CLE-NEWS.
- June 16-21, 1996 (Sponsored by ALI-ABA) **Estate Planning In Depth**, University of Wisconsin, Madison, WI. Telephone (800) CLE-NEWS.
- June 19, 1996 (Sponsored by Practicing Law Institute) **Elder Law Institute**, New York, New York. Telephone (212) 824-5700.

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Consider Uses and Costs of Residence Before Contributing it to Irrevocable Trust

Spouses typically own a residence as tenants-by-the-entirety to preserve continuity of ownership upon the death of a spouse. However, that survivorship estate may contradict a couple's estate plan. For instance, their plan may be designed to pass their residence through the first decedent's estate for a variety of reasons, including (1) to fund a testamentary trust to maximize the use of that decedent's $600,000 exemption equivalent, (2) to fractionalize the ownership of the residence for estate tax valuation purposes, or (3) to control the disposition of the residence upon the death of the surviving spouse (e.g., the residence may continue in trust to provide a home for minor children and their guardian).

The drafter should exercise caution where a testamentary trust may be funded with a residence (including a seasonal or vacation residence). Oregon statutory law governing the administration of trust assets may create an overly fertile ground for intra-family disputes concerning the use and management of the residence. To avoid these disputes and unexpected income tax consequences associated with holding a residence as a trust asset, the drafter should consider the issues identified in this article when drafting an irrevocable trust that grants a trust beneficiary the right to live in the residence. This article does not address the issues which affect the decision to fund an irrevocable trust with a residence or the income and estate tax issues relating to the control and sale of a residence held in an irrevocable trust.

Rent. Generally, a trustee has a duty to make trust property productive. Restatement (Third) Trusts (Prudent Investor Rule) § 181 (1992). A trustee is required to invest and manage trust assets as would a prudent investor by considering the purposes, terms, distribution requirements and other circumstances of the trust. ORS 128.196(1). However, a trustee is not liable to a beneficiary for failure to make an asset productive to the extent that the trustee acted in reasonable reliance on the provisions of the trust. ORS 128.194(2).

Unless directed to hold the residence, a prudent investor likely would not invest in a residence producing no rental income. Accordingly, if a trustee is to retain a residence and a trust beneficiary will be entitled to use a residence without paying rent, the trust should include an express provision authorizing the trustee to retain the residence and the beneficiary to use the residence rent free.

The trustee should also be alert to the issue of delayed income. A portion of the net proceeds of the sale of any part of trust principal which has not produced an

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average net income of at least 1% per year of its inventory value must be treated as delayed income to which the income beneficiary is entitled. In calculating the net income of a trust asset, the trustee is to include as income the value of any beneficial use of the property by the income beneficiary. ORS 129.105. Presumably, the value of the use of a residence includes the rental value of the property.

Use and Occupancy. The trustee must administer the trust pursuant to the terms of the trust instrument. ORS 128.055. Accordingly, a trust agreement should define the scope of the beneficiary's interest, the terms and duration of the beneficiary's use, and the conditions of sale or other disposition of the residence. Case law illustrates how litigation may arise if the trust instrument is ambiguous on these issues. E.g., *Rushlight v. Seton*, 145 Or 1 (1933) (beneficiary and trustee dispute over construction of new residence); *U.S. National Bank v. Anderson*, 133 Or App 628 (1995) (trustee sought to evict son and grandson living in a residence held for the benefit of the surviving spouse).

In defining use and occupancy, the estate planner must consider the specific facts and circumstances of the trust beneficiary. For this purpose, the estate planner should consider (1) who may occupy the residence with the surviving spouse, e.g., children, guardian, companions and siblings; (2) the duration of use, e.g., until a period of extended convalescence, a certain age, or the remarriage of the spouse; and (3) whether the beneficiary or the trustee will be responsible for maintenance, repair and insurance expenses.

The instrument should specify any conditions relating to the sale of the residence, for example, (1) whether the beneficiary or the trustee has the discretion to sell the residence; (2) whether the property is to be replaced if it is sold; and (3) whether there are any specific limitations to be placed on the purchase or construction of a new residence.

Allocation of Residence Costs. The trustee has a duty to administer the trust with due regard for the interest of the income and remainder beneficiaries. ORS 129.045(1). If the trustee is responsible for the payment of residence costs, this duty is met if income and expenses are allocated pursuant to the Principal and Income Act. *Id*.

Under the Principal and Income Act, ordinary expenses incurred in connection with the administration, management, or preservation of trust property, including regular recurring taxes, (except deferred real estate taxes assessed against any portion of principal), water rates, certain insurance premiums, mortgage interest and ordinary repairs are chargeable against income. ORS 129.115(1)(a). Conversely, mortgage principal payments and extraordinary repairs or expenses incurred in making a capital improvement to principal are apportioned to principal. ORS 129.115(3)(b) and (c).

The Principal and Income Act, however, is not appropriate for all situations. In allocating expenses, consideration should be given to the purposes of the trust, the resources available to the income beneficiary, and the nature of the trust assets. For example, if a trust contains a residence but insufficient assets to produce income to pay the costs of maintenance, repair and insurance, other sources must provide the cash flow to meet those obligations. Those resources may be the income beneficiary, a separate, funded trust, or trust principal (if the document expressly allocates the costs to it). On the other hand, if the residence is rented out and income is available to pay expenses, the drafter should consider allocating mortgage payments to income.

In appropriate situations, the drafter should evaluate and consider the utility of permitting the trustee to pay extraordinary expenses charged from a reserve account over a reasonable period of time. ORS 129.115. One of the purposes of a reserve account is to protect the principal of the trust against the building's value reduction attributable to depreciation of the structure. Generally, the trustee has no duty to establish a reserve and the remainder beneficiary cannot require the trustee to do so. Therefore, if the client anticipates that depreciation may affect the building's value and the client wishes to preserve the value for the remainder beneficiaries, the drafter should consider including language regarding a reserve account.

To provide greater flexibility, the instrument may grant an independent trustee discretion to allocate costs between income and principal. This discretion may apply to all allocations or may be limited to situations where the allocation rules are not clear, e.g., improvements or major repairs that primarily benefit the current beneficiary such as wheelchair access. Any discretionary allocations must be reasonable and equitable in view of the interests of all trust beneficiaries and in view of the manner in which persons of ordinary prudence, discretion and judgment would act in the management of their own affairs. ORS 129.045(1)(c).

Income Taxes. The income tax issues relating to occupancy of the residence must also be considered when allocating costs. Due to space constraints, this article does not incorporate a complete discussion of the income tax issues arising from the grantor trust rules of IRC sections 671-678. This article is limited to the discussion of case law and authority addressing the income tax treatment of occupancy costs.

Generally, the trust beneficiary does not receive imputed income by living in the residence rent free. Priv Ltr Rul 8341005 (6/24/83). Although interest and property taxes are deductible under IRC sections 163 and 164, the occupancy costs of a residence property are generally not tax deductible. *Norman H. Lane and Howard M. Zaritsky*,

Federal Income Taxation of Estates and Trusts, ¶ 4.09[1] at 4-38 to 4-39 (2d Ed, 1993). Commentators generally agree that occupancy costs are tax deductible if the residence is held for income production rather than personal use. If the beneficiary occupies the residence rent free for life, it will be impossible to assert that the residence is held for income production.

If repairs, utilities, insurance and similar costs that the trustee pays are not deductible for income tax purposes, their tax character depends upon the designation of such payments for fiduciary accounting purposes. *Id.* If occupancy costs are chargeable to trust principal, the current income beneficiary must include the entire income of the trust before reduction for such occupancy costs. On the other hand, if occupancy costs are properly payable from income, the payment of the costs is generally not a constructive distribution to the income beneficiary; instead, the trustee's payment of occupancy costs is regarded as income accumulated by the trust. *Id.* However, if the trustee pays costs from trust income primarily for the benefit of the beneficiary rather than for the administration, management or preservation of trust property, the beneficiary may be deemed to receive a constructive distribution. *Id.* In that case, the trustee's payment of occupancy costs from trust income would be taxable to the beneficiary.

Minor Children. An estate plan may direct that a residence be held in trust for the benefit of minor children and their guardian. In this situation, the drafter and client should consider additional issues: (1) whether to limit the retention of the residence until the beneficiary attains a specific age; (2) whether the trustees may remodel the residence as the children grow and their needs change; and, (3) in those situations where a guardian takes the children into his or her home and wishes to remodel the home to accommodate the minor children, whether the trustee may hold an equity interest in the guardian's residence equal to the value of the improvement.

If a residence is not placed into an irrevocable trust, the issues discussed in this article do not arise. Once a decision is made to place a residence in trust, no one boilerplate provision can address these issues. Any provision must be tailored to the desires of the client, the client's family situation and potential for family disputes, and the practical financial issues affecting the trustee's ability to pay occupancy expenses.

Tim Wachter

Preserving the Status of Community Property

Married couples domiciled in a community property state have rights different from those of married couples in a common law state. The most notable distinction is that when property is characterized as community property, a couple can save substantial income and estate taxes. This article discusses the tax advantages available to married couples when they preserve their property's community status after migrating to Oregon from a community property state.

There are eight community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington. Wisconsin has a form of marital property similar to community property but not designated as such.

Although Oregon is a common law state, it has adopted the Uniform Disposition of Community Property Rights at Death Act. When a married couple moves community property into a common law state, and one spouse subsequently dies, the Act clarifies the property rights of the surviving spouse. Generally speaking, the Act provides that moving to a common law state will not change the property rights of the husband or wife. Because there are hundreds of married couples moving to Oregon from community property states, it is important for estate planning attorneys to be familiar with all of the advantages of preserving a couple's community property. Although under some circumstances, community property status should be changed, this article will discuss only the advantages of preserving community property status.

Definition of Community Property.

Generally, community property is all property acquired during marriage, by the labor or skill of either spouse, while domiciled in a community property state. On the other hand, separate property, in a general sense, is property owned by either spouse before marriage or property one spouse acquires after marriage by gift, descent or devise.

Advantages of Community Property.

There are two ways in which residents of community property states enjoy potential advantages over residents of common law states. First, two gross estates are available to married couples, even when only one spouse has been acquiring property through the course of the marriage. Second, the surviving spouse's basis in his or her own half of the community property that has appreciated in value is stepped-up to its value at the date of the decedent spouse's death or alternate valuation date.

1. **Two Gross Estates**. Under the community property system, the marital community estate is divided or split equally into two gross estates. When only one of the spouses is a wage earner, or an "acquiring spouse," significant estate tax advantages are available if the couple resides in a community property state. Because those earnings, and the acquisitions made with those earnings, are community property, if the non-acquiring spouse dies first, then one-half of the couple's community property is included in his or her gross estate.

However, in Oregon, as well as other common law states, if one spouse owns no separate property, that spouse would have no gross estate if he or she died first. Because the non-acquiring spouse would have no gross estate, there would be no federal estate tax due. However, upon the later death of the acquiring spouse, all of the property acquired during the marriage would be in that spouse's gross estate, and the couple would have lost the opportunity to utilize the first spouse's unified credit.

Although a married couple in a common law state may take steps during their joint lifetimes to equalize their estates, equalization is automatic for married couples with property consisting solely of community property. Thus, no matter which spouse dies first, a credit shelter trust in a properly drafted testamentary disposition plan will preserve the first spouse's unified credit.

2. **The Step-Up In Basis.** Under the community property system, if at least one-half of the whole community interest is includable in the decedent's gross estate, then not only does the decedent spouse's half of the community property receive a new basis, the surviving spouse's half also receives the same treatment. IRC § 1014(b)(6). Thus, if the community property has appreciated in value, then both halves of the community property will receive a stepped-up basis to the fair market value at the date of the decedent's death, or to the value at the alternate valuation date.

In contrast, if the property is held jointly in a common law state, only one-half of the property that has appreciated in value is stepped-up at the death of one of the spouses. If the property is owned separately by one spouse, the property receives a full step-up in basis at the death of such spouse. However, if the nonacquiring spouse dies first, the separate property of the surviving spouse will not be stepped-up until he or she later dies. Unfortunately, at that time there is no surviving spouse to take advantage of the income tax savings upon a subsequent sale.

With community property, no matter which spouse dies first, the entire basis of the property is stepped-up at the time of the first death. Thus, there can be significant income tax advantages when community property has appreciated in value at the time of the first spouse's death.

Preserving Community Property When Migrating to Oregon

When moving into Oregon, if steps are not taken to preserve the character of the community property, and if community property is commingled with separate property, the community property status may be lost. An attorney should advise clients who have recently moved to Oregon from a community property state to make a complete inventory of property. If this is done, the status of property can be traced upon a subsequent death. Also, the attorney should advise the couple that when they register their property in Oregon after their move, they should execute a contemporaneous agreement, stating their intention to maintain the property's community status.

Another method of minimizing subsequent tracing problems is to transfer the community property into a revocable living trust. Rev. Rul. 66-283 holds that if such a trust is properly drawn, it will maintain the community property character of the corpus for income tax purposes and should save the stepped-up basis.

Once the couple's agreements are in place, the attorney's role may not end. If the couple continues to actively buy and sell assets, then documentation tracing the source of the property will need to be maintained. If an agreement has been established preserving the community status of property, then all subsequent uses of the proceeds must also take this character. If one spouse takes sole title to assets representing the proceeds of community property, then the IRS could argue that a severance has occurred. To avoid this risk, the couple may need assistance in recordkeeping to identify and trace the proceeds.

Conclusion.

Oregon is experiencing an influx of out-of-staters. Estate planning attorneys in Oregon should take note of where their clients have lived. During the initial consultation with the clients, the attorney should ask the couple detailed questions about their residency in Oregon: how long have they lived in Oregon; have they ever lived in one or more of the community property states; what property did they acquire while they were residing in the community property state; how did they dispose of the property; were they married the entire time they were residents of the community property state. By obtaining the necessary information from clients who have moved from community property states, and assisting the clients with the proper agreements and documentation, an attorney can enable the clients to enjoy the income tax and estate planning benefits inherent in community property.

Janice E. Hatton

The Advantages and Problems With Using Tax Basis Revocable Trusts

One of the hot topics in Oregon (as well as many parts of the U.S.) is whether on the death of one spouse, the surviving spouse in a common law jurisdiction can obtain a step-up in basis in both spouses' property through a tax basis revocable trust. Salem attorney Paul Fletcher's "How To" book on this subject uses the following example:

> Husband (H) and wife (W) set up a joint revocable trust. W transfers $470,000 worth of property to the trust. H transfers $435,000 of property to the trust. Under the terms of the trust, H has a power of appointment over W's half of the property and W has a power of appointment over H's half of the property. This power is a power to pay the creditors of the deceased spouse's estate, and is exercisable only before the holder's death (and not during the administration of the holder's estate) and only when notice is given. It can be limited only to appreciated property and only to the extent the first spouse's assets are insufficient to satisfy the estate's obligations. W dies first and her $470,000 goes into a credit shelter trust with H as a beneficiary.

It is Fletcher's position that: (A) the power of each spouse is a general power of appointment, so that the property originally transferred by H is includable in W's estate under IRC § 2041, (B) H can disclaim as to $130,000 of property originally transferred by H, so that W's unified credit is fully utilized, (C) as to H's remaining $305,000, H has a power to revoke the trust that is equivalent to an unlimited power under a general power of appointment trust and consequently qualifies for the marital deduction under IRC § 2056, and (D) H obtains a step-up in basis in all $905,000 of property, similar to the rule for community property under IRC § 1014(b)(6). This article will discuss these four issues.

A. The Power of Appointment Issue.

For estate tax purposes, when W dies, half of the jointly-held property transferred into trust is taxed under IRC § 2040. W's separately-held property will also be taxed, because of her power to amend or revoke the trust as to this property under IRC § 2038. Usually, the estate of the first spouse to die will not include the survivor's one-half of the jointly-held property or any of the survivor's separately-held property transferred into trust. However, with respect to the above fact pattern, Fletcher argues that the general power of appointment of each should include all of the other's property in the taxable estate of the first to die. Thus, the question arises: Does W have a valid general power of appointment over H's interest in the trust assets, since H has a right to amend or revoke as to such assets? If not, there is no inclusion of the value of this property in W's estate and the step-up in basis issue does not arise.

There are precedents that a power to appoint to one's creditors can be a general power, despite the fact that the power holder must give notice of the exercise of the power. Thus, the notice and "payment to creditor" provisions in the above fact pattern create no problems as to the existence or validity of the IRC § 2041 power. There are also precedents that a general power of appointment does not exist when it "is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency which did not take place or occur during such time." Treas. Reg. § 20.2041-3(b). W's IRC § 2041 power, however, does not depend on something happening. Instead, the power is exercisable in any event. Since the power can be divested at the whim of H, however, it is arguably illusory and invalid. Unfortunately, there is no precedent that would help us here, but the divestment power may mean that there is no IRC § 2041 power in W.

Even if a power exists and is valid, it may not be general, because its exercise may only be "in conjunction with the creator of the power" or "in conjunction with a person having a substantial [adverse] interest in the [appointive] property" under IRC § 2041(b)(1)(C)(i) and (ii). Arguably, W effectively needs H's consent in this case, because H could revoke the trust as to his part of the assets upon receiving W's notice of her intention to exercise her power of appointment.

B. The Disclaimer Issue.

The issue as to H's disclaimer right is very significant, because its exercise could have adverse gift tax and estate tax consequences to H. Even assuming a valid general power and inclusion of all of the trust property in W's estate, how can H disclaim something which is already his and subject to his control? If a general power does not exist and H's assets are not included in W's estate, his disclaimer of $130,000 will not qualify under IRC § 2518.

If H's "disclaimer" is not qualified, it constitutes a taxable gift of the remainder interest in his $130,000. No part of this gift would be eligible for the gift tax annual exclusion under IRC § 2503(b), because it would not be a gift of a present interest. If H has made no prior taxable gifts, this gift would be sheltered by his unified credit. However, from an estate tax standpoint, H's right to receive income from his $130,000 under the credit shelter trust could constitute a retained life estate under IRC § 2036(a), causing some inclusion in his taxable estate at his death. Although the same property would not be taxed twice, the benefit of

transferring the $130,000 to the credit shelter trust would be lost.

C. The Marital Deduction Issue.

If the property H transferred to the trust is included in W's estate, then in order to avoid estate taxes on W's death, the portion of H's $435,000 that causes W's taxable estate to exceed $600,000 ($305,000) must qualify for the marital deduction. The marital deduction is allowed only when an interest in property passes to the surviving spouse and the interest is not a terminable interest. IRC §§ 2056(a) and (b).

Query whether any property passes to H from W when H continues to hold a power to revoke as to his transferred property. Assuming that W held a valid general power over the transferred property, resulting in inclusion of the value of that property in her estate under IRC § 2041, then on W's death the power lapsed and the property passed to H. Consequently, it should meet the passing requirement of the marital deduction because lapse constitutes passing under IRC § 2056(c)(6).

Another requirement for the marital deduction is that the interest not be terminable. The property H "receives" from W — $305,000 — is subject to H's power to revoke. This power to revoke is similar to a general power of appointment that qualifies for the marital deduction under IRC § 2056(b)(5). Thus, if there is a transfer from W to H, the property qualifies for the marital deduction.

D. The Income Tax Basis Issue.

If W's estate includes H's assets under IRC § 2041, the next question is whether there is a step-up in basis of the property subject to that power. IRC § 1014(b)(9) initially would indicate the answer is yes, assuming "property [was] acquired from the decedent." Again, query whether any property has passed from W to H. However, the IRS has issued a Technical Advice Memorandum, TAM 9308002, holding that no step-up is allowed in the situation described above under IRC § 1014(e). That IRC section was passed to prevent a step-up when "an heir can transfer appreciated property to a decedent immediately prior to death in the hope of receiving the property back at the decedent's death with a higher basis." (S. Rep. No. 1622, H.R. 8300. Internal Revenue Code of 1954.) For a step-up to be prevented by IRC § 1014(e), "appreciated property" must have been acquired by the decedent by gift during the one year period ending on the date of the decedent's death and such property must be "acquired [back] from the decedent" by the donor of such property.

The question here is: Was there a gift by H of his $435,000 to W, and was it a completed gift? If so, when did the gift arise? There may be no gift, as Fletcher claims, because there was no "beneficial interest" given — as required by the gift tax rules. Because one spouse has the power to revoke the trust as to the property over which the other spouse has a general power of appointment, there may be no gift since any transfer would be incomplete.

The TAM seems to indicate that there is a gift at death and thus step-up is prevented by IRC § 1014(e). This position makes sense, given the purpose of the statute and given the fact that H's $435,000 is includable in W's estate under IRC § 2041. However, the TAM goes on to state that "the property" was never "acquired from the decedent" by the surviving spouse, because the donor never relinquished "actual dominion and control over the property" in that he "could revoke the trust at any time." This conclusion is inconsistent with the TAM's finding that a gift occurred — and arguably a gloss, as Fletcher argues, on the legislation. If there was a completed gift to the decedent, it logically follows that someone — in this case H — acquired the property from the decedent.

If there was a gift, however, a gift tax on H's transfer should result. Unfortunately, no marital deduction may be allowed for this gift because (1) the power may not be "an interest in property" under IRC § 2523(a) and (2) if qualifying as "an interest," it may be terminable and thus prohibited from deduction under IRC § 2523(b). Since it is likely that no general power of appointment exists in the first place, no step-up should result from a tax basis revocable trust. If there is an inclusion under IRC § 2041, then a gift occurs at the moment of W's death, and IRC § 1014(e) would prevent the step-up.

Conclusion.

The potential adverse tax consequences of tax basis revocable trusts are substantial. First, a general power of appointment clause could cause property subject to that power to be includable in the first spouse's estate. Second, a disclaimer may be invalid causing a gift tax to the surviving spouse and adverse estate taxes upon that spouse's death. Third, no step-up in basis for the property included in the first spouse's estate may occur. Because of the uncertainty of the law in this area, practitioners should be cautious in drafting these trusts.

Nancy E. Shurtz

What's New

IRS Issues Proposed Regulations Affecting Entity Classification

The IRS has finally issued its so-called "check-the-box" rules for the classification of unincorporated associations. Under the proposed regulations, issued under IRC § 7701, all businesses organized as partnerships or limited liability companies under state law will automatically be treated as partnerships for federal tax purposes, unless they elect out of such treatment. Corporations are not eligible for treatment as partnerships for tax purposes.

Under current rules, partnerships and LLCs must be treated as corporations for tax purposes if they have predominately corporate characteristics. Taxpayers are required to shape their business entities to avoid these characteristics. The rules are a trap for the unwary, with potentially disastrous tax consequences.

The new regulations will not apply until the date they are published as final regulations. Existing regulations will continue to apply until then. However, the IRS will not challenge the classification of an existing entity prior to the effective date of the final regulations if the entity has a reasonable basis for its claimed classification.

Supreme Court to Settle Effect of Administration Expenses Charged Against Income of Marital Bequest

The Supreme Court agreed on April 29 to settle a conflict between the Sixth and Eleventh Circuits as to whether the estate tax marital deduction must be reduced by administration expenses charged against income from property passing to the surviving spouse. Where expenses of estate administration are charged against the income of property passing to a surviving spouse, the Tax Court, in an opinion adopted by the Eleventh Circuit, held that the regulations did not mandate a set off against the marital deduction. The Tax Court interpreted the applicable regulation (Reg. § 20.2056(b)-4(a)) to require that material limitations on the right to receive income must be taken into account in valuing the property passing to the surviving spouse, but it held that using income from such property to pay estate administration expenses was not necessarily a material limitation. *Estate of Hubert Otis v. Comm.* 101 T.C. 314. In an earlier case, the Sixth Circuit, in reversing the Tax Court, held that the regulation requires the marital deduction to be reduced to reflect the amount of income used by an estate to pay administration expenses. *Estate of Gordon Street v. Comm.* 974 F.2d 723 (1992).

District Court in Fourth Circuit follows Sixth Circuit Opinion in *Gallenstein*

Spousal joint tenancies created before 1977 were fully includable in the estate of the first spouse to die except to the extent the surviving spouse contributed to the purchase price. As a result, the non-contributing surviving spouse received a basis step-up on the entire value of the property. In 1976, Congress added IRC § 2040(b), which allowed spouses who created certain joint tenancies after 1976 to treat one-half of the property as owned by each of them. Congress amended IRC § 2040(b) in 1981 to make the 50% rule mandatory for all jointly held property of spouses, and provided that the changes were "applicable to estates of decedents dying after December 31, 1981."

The issue in *Gallenstein v. U.S,* 975 F.2d 286 (6th Cir. 1992) was whether the amendments to IRC § 2040 made in 1981 effectively repealed the old rules. In a holding that surprised many practitioners, the Sixth Circuit held that they did not. For joint tenancies established prior to 1977, the contribution rules of IRC § 2040(a) continue to apply. In *Patten v. U.S.,* 1996 U.S. Dist. LEXIS 5441 (W. Va. 1996), the District Court followed the Sixth Circuit's analysis in *Gallenstein* in reaching an identical conclusion. The District Court allowed a full basis step-up, even though the deceased spouse's estate (improperly) included only fifty percent of the value of the property on the estate tax return.

Although the IRS will likely continue to contest this issue, practitioners with clients who reported gains on sale of inherited property using a fifty percent basis step-up should consider filing refund claims to claim a full basis step-up, where the *Gallenstein* rule would apply.

Stephen J. Klarquist

Questions, Comments or Suggestions About This Newsletter?

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CALENDAR OF SEMINARS AND EVENTS

- July 26-27, 1996 (Sponsored by ALI-ABA) **Estate Planning Techniques**, Anchorage, Alaska. Telephone (800) CLE-NEWS.
- July 31, 1996 (Sponsored by Practicing Law Institute) **Understanding Basic Estate Planning**, New York, New York. Telephone (212) 824-5700.
- August 1, 1996 (Sponsored by National Business Institute) **Basic Probate Procedures and Practices**, Oakland, California. Telephone (715) 835-7909.
- August 22-24, 1996 (Sponsored by ALI-ABA) **Post Mortem Planning and Estate Administration**, Rittenhouse Hotel, Philadelphia, Pennsylvania. Telephone: (800) CLE-NEWS.
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- September 19, 1996 (Sponsored by ALI-ABA) **Annual Fall Estate Planning Practice Update**, 70+ Cities. Telephone (800) CLE-NEWS.
- September 19-20, 1996 (Sponsored by Practicing Law Institute) **27th Annual Estate Planning Institute**, New York, New York. Telephone (212) 824-5700.
- September 26-28, 1996 (Sponsored by the Southern California Tax & Estate Planning Forum) **The Sixteenth Annual Southern California Tax and Estate Planning Forum & Workshops**, Sheraton Harbor Island Resort, San Diego, California. Telephone (800) 332-3755.
- October 3-5, 1996 (Sponsored by ALI-ABA) **Pension, Profit-Sharing, Welfare, and Other Compensation Plans**, Washington, D.C. Telephone (800) CLE-NEWS.
- October 16-18, 1996 (Sponsored by ALI-ABA) **Uses of Insurance in Esta[illegible] and Tax Planning**, Stanford Court, San Francisco, California. Telephone (800) CLE-NEWS.

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Structuring the Family Limited Partnership: Avoid the Traps Laid by Section 2704

The use of family limited partnerships in estate planning has grown exponentially in recent years, and for good reason. Gift and estate valuation discounts of 30 to 50 percent of the net asset value of assets used to fund the partnership can often be substantiated. To obtain these discounts, practitioners must be thoroughly familiar with the Internal Revenue Code provisions applicable to valuing interests in family-held partnerships, particularly §2704. Section 2704 has the potential to wreak havoc on anticipated valuation discounts and its application should be carefully avoided.

Section 2704 applies to family-controlled partnerships, that is, partnerships in which family members hold 50% or more of either capital or profits interests of the partnership. (Note that while § 2704 also applies to corporations and limited liability companies, its application to those entities is beyond the scope of this article.) "Family members" is defined broadly, and includes an individual's spouse, ancestors, lineal descendants of the individual or his spouse, brothers and sisters of the individual, and any spouse of the foregoing. It is assumed in this article that the entity is entirely family owned, as in the typical situation in which one or both parents are establishing the partnership with their children.

Section 2704 has two parts: § 2704(a), which addresses lapsing voting and liquidation rights, and § 2704 (b), which addresses restrictions of liquidation rights. This article briefly discusses each of the two subsections, and then examines how the section applies to common limited partnership arrangements.

Section 2704(a)

Section 2704(a) provides that a lapse of a voting or liquidation right is treated as a gift or bequest to the extent the value of the interest of the person holding the right decreases as a result of the lapse. This section was inspired by a U.S. Tax Court case, *Estate of Harrison*, T.C. Memo 1987-8, which involved the valuation of family partnership interests. The partnership was formed by Mr. Harrison and his two sons six months before Mr. Harrison's death, with $59 million of his assets. The decedent retained a 1% general partnership interest and a 78% limited partnership interest. His children each held 10.5% interests as general partners. Each general partner held a unilateral right during life to liquidate the partnership. The court held that because the liquidation right expired at death, the interest must be valued for death tax purposes as if it had no liquidation rights, even though the decedent could have liquidated the company and received the full net asset value of

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his interest during his lifetime. This is consistent with general estate tax valuation tenets, under which the value of property that *passes* to the heirs and devisees is taxed, not necessarily the value of what the decedent held. See *Propstra v. U.S.*, 680 F.2d 1248, 50 AFTR2d 6150, 6155 (9th Cir. 1982). Moreover, the property interest passing to the heirs is valued at the price at which a hypothetical willing buyer would pay to a willing seller for the interest. The court held in *Harrison* that that price was $33 million.

Section 2704(a) changes that result. Now, as a general rule, the lapse of a voting or liquidation right with respect to an interest held in a family corporation or partnership is treated as a taxable transfer for estate and gift purposes. The amount of the transfer is the difference between (1) the value of all of the interests held by the holder of the lapsed rights before the lapse (determined as if the rights were non-lapsing) over (2) the value of the interests immediately after the lapse.

Section 2704(a) does not apply to all voting and liquidation rights in family held entities. A lapse does not occur if the rights with respect to the transferred interest are not restricted or eliminated, but instead pass to the transferee of the interest. Reg. § 25.2704-1(c). A classic example is the transfer of voting stock. Absent some restrictive agreement among the shareholders, the transferee has all the rights as a shareholder that his transferor held.

Section 2704(a) also does not apply to a liquidation right or a voting right, if immediately after the lapse the holder of the lapsed right (or his estate) and members of his family cannot liquidate the partnership interest that the holder could have liquidated prior to the lapse. For example, in *Estate of Harrison*, the decedent's sons could have agreed to dissolve the partnership after the decedent's death, effectively liquidating his interest. Giving a limited partnership interest to a non-family member is one way to prevent the family from simply agreeing to liquidate; the consent of all parties is required to dissolve the partnership. ORS 70.325(3).

Section 2704(b)

Section 2704(b) provides that if an interest is transferred (by gift or bequest) to a family member, then in valuing the interest for gift or estate tax purposes, a restriction on the rights of the owners to liquidate is ignored if (1) it is more restrictive than those imposed under state law, *and* (2) after the transfer either (a) the restriction lapses according to its terms, or (b) the transferor (or his estate) and family have the ability under state law to remove the restriction. Restrictions that meet these requirements are called "applicable restrictions." Reg. § 25.2704-2.

For example, partnership P has 100 "units" of ownership outstanding: 3 general partnerships units and 97 limited partnership units. D and his children, A and B, each own one general partnership unit; D holds 87 of the limited partnership units; A and B each own 5 limited partnership units. D makes gifts of a portion of his limited partnership units to A and B. The partnership agreement has a continuation clause which provides that upon the withdrawal of any general partner, the business of the partnership may be carried on by the remaining general partners. In absence of this clause, ORS 70.325(4) provides that the withdrawal of a general partner causes a dissolution of the partnership, unless all partners agree in writing to continue the business of the partnership. The continuation clause is more restrictive than the state law generally applicable, and can be removed by a vote of the family members after the gift. It is therefore an applicable restriction, and must be regarded. Without restrictio, any one of D, A or B could effect a dissolution of the partnership simply by withdrawing as a general partner, and voting his remaining limited partnership interest against continuation. The gifted interest in that case must be valued as if the recipients, A and B, could obtain the liquidation value of their interests.

Section 2704(b) can work in combined application with other code sections. The regulations provide, as an example, that an applicable restriction attached to preferred stock will be disregarded in determining the amount of a transfer of common stock under § 2701. Reg. § 25.2704-2(c). Presumably, it can apply in conjunction with § 2704(a), as well. For example, one way to avoid a lapsing liquidation right under § 2704(a) is to avoid having a liquidation right in the first place. A restriction on a liquidation right that is an "applicable restriction" may be disregarded under § 2704(b), and cause an unanticipated taxable lapse of a liquidation right which was assumed did not exist.

Structuring the Agreement

The best way to avoid § 2704 is to structure the partnership in a manner that does not give liquidation rights (determined by disregarding "applicable restrictions") to persons for whose interests discounts are sought, or to family members to whom interests are transferred. Unfortunately, the most common arrangements invite application of § 2704, at least with respect to interests retained by the parents. This portion of the article discusses these arrangements, and proposes alternatives that will avoid § 2704.

Arrangements Subject to § 2704

Parent as sole general partner, *with no* limited partnership interests. ORS 70.255(1) allows a general partner to withdraw from the partnership at any time. ORS 70.260 provides that upon withdrawal, any withdrawing partner is entitled to receive the fair value of the withdrawing partner's interest in the limited partnership, based upon the withdrawing partner's right to share in distributions from

the limited partnership. The meaning of "fair value" is unclear, and no Oregon case (or for that matter, apparently any case) has discussed its meaning, but at least some legal scholars have concluded that fair value should generally equal the partner's proportionate share of the net asset value of the partnership's assets. Kessler, "*The New Uniform Limited Partnership Act: A Critique,*" 48 Fordham Law Review, 159, 171 (1979); Hecker, "*The Revised Uniform Limited Partnership Act: Provisions Governing Financial Affairs,*" 577, 617 (1981). If this liquidation right lapses upon the death of the general partner, or upon the transfer of the interest by gift, § 2704(a) will mandate that the general partnership interest be valued taking into account the liquidation right. This is true whether the partner is a sole general partner, or is serving as one of several general partners.

Parent as sole general partner, with limited partnership interests. This would be a typical arrangement for a parent who plans on making future gifts of the limited partnership interests. The issue here is whether a parent's small general partnership interest might be valued at net asset value, but the discounts would be available for her limited partnership interest. ORS 70.325(4) provides that the withdrawal of a general partner causes a dissolution of the partnership, unless there is at least one other general partner and the written provisions of the partnership agreement permit the business to be carried on by the remaining general partner and that partner does so, *or all partners (limited and general) agree to continue the business, and to appoint a new general partner if necessary.* A general partner who also holds a limited partnership interest has, with respect to her limited partnership interest, the powers of a limited partner to the extent of her interest in the partnership as a limited partner. ORS 70.190. If the parent is serving as sole general partner and also has a limited partnership interest, the parent can effectively cause a liquidation of the entire partnership by withdrawing as general partner and voting her limited partnership interest against continuation. If this liquidation right lapses at the death of the parent, §2704(a) will apply.

Gifts of limited partnership interests to the children under this scenario will not be valued under §2704. No lapse of a liquidation right will occur with respect to the gifts, and the children will not have a right to liquidate the gifted interests, whether they are admitted as limited partners, or receive only assignees' interests. Consequently, § 2704 will not affect the use of any discounts otherwise applicable to valuing the gifts.

Parent as one of two or more general partners, *with* limited partnership interests. This is also a typical arrangement. The parent's spouse or children, or both, might hold general partnership interests. The partnership agreement will contain a continuation clause that allows the remaining general partners to continue the partnership. The issue here is whether the continuation clause in the partnership agreement can prevent the parent from forcing a dissolution of the partnership. The right of a remaining general partner to continue must be provided for in the partnership agreement, and is therefore an "applicable restriction" under § 2704(b), because it is more restrictive than the default rule under state law and can be removed by the remaining partners (all of whom are family members) after the transfer. Consequently, the partnership must be treated as if the remaining general partners did not have the right to continue the business without the consent of all the limited partners. The withdrawing general partner can again vote her limited partnership interest to dissolve the partnership.

Gifts may or may not be subject to § 2704(b), depending on whether the children (donees) have rights under ORS 70.325(4) to liquidate the partnership and receive the full value of the gifted interest. If they hold general partner interests, and are admitted as limited partners with respect to the gifted interests (rather than holding the interests as mere assignees), or already are limited partners, they would have that right. Consequently, if the children hold interests in the partnership as both general and limited partners, the gifted interest will be valued taking the children's liquidation rights inaccount.

Arrangements Avoiding § 2704

Give general partnership interests only to children. A retention of solely a limited partnership interest will not give the parent looking for discounts any liquidation rights. Because the parent loses *de jure* control, however, this option may not be palatable to most clients. Elderly clients with close, trusting relationships with their children may tolerate this arrangement. A variation of this option might be to give a spouse (who is not contributing substantial assets) a general partnership interest. This should ensure that the contributing spouse obtains discounts for his limited partnership interest.

The limited partnership interest should not pass to the spouse who is serving as general partner or the problems discussed above will arise. The interest could instead be conveyed to a QTIP trust or credit shelter trust so that the surviving spouse does not own both general and limited partnership interests. The interests should not be aggregated for valuation purposes. *Estate of Bonner*, 77 AFTR2d 96-2369 (5th Cir. 1996) (See p. 7 of this newsletter). The IRS takes a contrary view. PLRs 9608001 and 9550002.

Note that if gifts of limited partnership interests by the parent are contemplated, the partnership must be structured so that the children do not have liquidation rights. Gifting

only assignees' interests would prevent a child serving as a general partner from blocking a continuation vote in the event of withdrawal.

Establish an S corporation to serve as general partner. The basic idea is to give the corporation a one percent interest in the partnership. The parents would each own 49% or less of the stock, with the children owning the balance. A single parent could own 49%, with the children holding the balance. This would prevent any one shareholder from having the control needed to cause the corporation to withdraw as general partner, and thereby effectively cause a dissolution of the partnership. An added benefit to the arrangement is that it would give full limited liability to the parents.

The drawbacks to having a corporation serve as general partner are at least two-fold. First there is the added administrative burden and expense. Additional tax returns will need to be prepared, and all the corporate formalities will need to be complied with. Second, the IRS may treat the limited partnership as having the corporate characteristic of "limited liability" unless the corporation has deep pockets. Capital of at least 10% of the total capital of the limited partnership is the "safe harbor" threshold. Rev. Proc. 89-12, § 4.07. This should not be a factor if the partnership lacks the corporate characteristics of free transferability and continuity of life, and may not be a factor at all under the proposed new entity classification regulations.

Give limited partnership interest to non-family member. Section 2704(b) does not apply to a restriction on liquidation which the transferor (or his estate) and his family cannot remove immediately after the transfer. The ULPA is silent regarding the amendment of a partnership agreement. A partnership agreement, being a contract among the partners, should be governed by general contract principles, which require that all parties to a contract must consent to amend the contract. This suggests that a way to avoid the application of § 2704 to the entire arrangement is to give a limited partnership interest to an outsider. For example a limited partnership interest could be given to a charitable remainder trust with an independent trustee, or directly to a charitable organization which is not controlled by the family. Consequently, restrictions on liquidation would never be "applicable restrictions." Section 2704(a) could be avoided simply by using multiple general partners and inserting a continuation provision in the partnership agreement.

Granting an outsider a limited partnership interest would also avoid one unresolved trouble area. If a limited partnership does not provide a definite time for dissolution and winding up (i.e., a fixed time at which liquidation will occur), a limited partner may withdraw after giving six months notice, and receive the fair value of his interest based upon his right to share in distributions from the limited partnership. ORS 70.260. Is the establishment of a fixed term an "applicable restriction"? Commentators have argued that inclusion of a definite time for dissolution is not an" applicable restriction," especially if the state law effectively requires a definite time. *See* S. Stacy Eastland, *The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: The Use of Family Partnerships in Estate Planning*, Portland Tax Forum Outline for Nov. 10, 1995 presentation, at pp. 32-37. *See also* Kenneth P. Brier, *Family Limited Partnerships and Chapter 14: Some Estate Planning Perspectives*, 21 ACTEC Notes 297 (1996) (arguing that the doctrine of facts of independent legal significance should apply, i.e., the actual provisions of the partnership agreement should not be ignored in determining which provisions of state law apply, as long as they are not directly a restriction on liquidation and have significant effects on the partnership beyond the restriction on liquidation). The IRS has apparently taken the informal position that an applicable restriction results from the inclusion in a partnership agreement of the time or events of dissolution. (See U.S. Trust - Practical Drafting, October 1994, at p. 3773.)

Conclusion

This article has taken a "worst-case scenario" approach to interpretation — an approach likely to be taken by the Internal Revenue Service. Its aim is to help the practitioner avoid the application of § 2704 to the greatest extent possible. But are the issues discussed in this article moot?

It has been argued, and the author agrees, that § 2704(a) is unconsitutional (see the Eastland article, pp. 3-5, cited above), because it taxes property held by a transferor (decedent or donor) immediately *before* the transfer, and not the value of the property actually transferred. Similarly, it has been argued that § 2704(b) has little practical impact on valuation, because a hypothetical buyer of a partnership interest would never pay more than the value of an *assignee's* interest, rather than a full partnership interest, because he would not have full rights of a partner unless admitted as a partner by the other partners. The partnership interest would therefore be discounted in value notwithstanding that "applicable restrictions" are disregarded. Eastland, *supra*, at p. 12.

It is the rare client who would willingly test the constitutional waters of § 2704. And the parameters of either subsection have yet to be tested in the courts. The not-so-fun, but cautious, approach is to interpret the statute in a manner the IRS would, and plan accordingly.

Stephen J. Klarquist, LL.M.

Problems for Owners of Annuities in Estate Planning and Administration

Introduction

Commercial annuities issued by insurance companies have become a popular investment device in the 1990s. Clients will often identify "annuities" as principal assets owned as part of their estates. The peculiarities of these investment contracts present special problems to the estate planner and the attorney advising the executor or successor trustee in administering a decedent's property. Annuities have become a "species of property" that need special attention. The following is a short overview of some major considerations.

What is an annuity?

For purposes of this discussion we are not considering "qualified annuities" which are issued by tax qualified retirement plans or 403(b) tax deferred savings plans for exempt organizations or teachers. In general, the commercial annuity we consider is a contract between an owner of the contract (our estate planning client or the decedent) and an insurance company to pay certain amounts to designated persons in the future. Like other investment contracts, certain rights can be transferred or assigned by the owner, either during lifetime or at death, and the asset can be transferred at the death of the owner to a successor outside of the probate estate.

Terminology

"**Owner**." Like the owner of a life insurance contract, this is the party who controls the contract and can make certain changes. The owner, while alive, has the right to surrender the contract for cash, make permitted withdrawals, convert to another contract, and change the designation of beneficiary or successor owner.

"Annuitant." Under the contract, there will be periodic payments made to the annuitant beginning when the annuitant reaches a specified age (usually 65 or later). The annuitant may be the owner or some other person. Under the usual arrangement, an older person will purchase the contract and become the owner of the contract, naming a much younger person (child or grandchild) as the annuitant. In this way contractually required payments may be substantially deferred. For example, the contract might provide that periodic distributions only begin to the annuitant when the annuitant (child) is age 85 (well beyond the life expectancy of the parent owner).

"Beneficiary." While an annuity is an insurance company product, the concept of beneficiary is much different than under a life insurance contract. The beneficiary is the person who receives required annuity payments under the contract after the death of the annuitant. Given the typical deferral of required annuity payments, the designation of beneficiary may not be important.

"Successor Owner." This is the person, designated in the contract, who will own the contract after the death of the owner. A contract that does not contain successor owner provisions will become an asset of the owner's estate.

"Surrender Charges." This is a dollar amount penalty imposed by contract, usually expressed as a percentage of the total contract value, which is subtracted if the contract is surrendered or withdrawals are made in the early stages of the contract. For example, in the first year of the contract the surrender charge might be 7%, and the second year 6%, etc. The surrender charge is usually imposed upon withdrawals in excess of some floor percentage of the contract value. A typical surrender charge floor would be 10% of the contract value. In other words, 10% of the contract could be withdrawn each year with no surrender charges. The surrender charge is usually renewed if the annuity is "rolled over" into a new contract.

"Premature Distribution." In general, a withdrawal before the recipient is age 59-1/2 is subject to a 10% federal excise tax on premature distributions. There are many exceptions, including payment because of death of the holder. IRC § 72(q).

Typical Arrangement

The client, frequently an older individual, will purchase the annuity for a lump sum payment and designate a child as the annuitant, with the other children as beneficiaries (or possibly grandchildren). Earnings on the contract accumulate without current income taxation, and can be withdrawn by the owner under the surrender charge and premature distribution rules before the annuity starting date. Any withdrawals by the owner are taxed first as withdrawals of earnings, and after all earnings are withdrawn, next from investment in the contract (tax free return of prin-

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cipal). When the owner dies the successor owner (or estate) usually continues to have the same options of withdrawal subject to income taxation and surrender penalties, if any are still in force. The estate planner should carefully review the actual contract to determine the contract options available, and should confirm those options and their tax consequences in writing with the insurance company.

Income in Respect of a Decedent

An annuity contract owned at death likely will have built-in taxable income to the extent of the contract earnings not withdrawn by the decedent ("income in respect of a decedent"). Unlike assets eligible for a stepped-up basis, the annuity contract carries its income tax liability to the estate of beneficiaries. If, under the estate plan, the annuity is allocated to one beneficiary while another receives stepped-up basis property (for instance stock or real property), an inequitable distribution can arise.

Surrender Charges

As mentioned above, the surrender charges that may be imposed at the time of the owner's death usually continue after the owner's death, unless the contract provides otherwise. In distributing the estate the fiduciary will need to consider liquidating the contract or the possibility of transferring the contract among beneficiaries (for instance in equal shares among children). If the contract is distributed, then the beneficiaries will have to decide how to control the annuity payouts among themselves. If regular annuity payments have not begun, the entire contract must be distributed within 5 years of the owner's death or converted to a life annuity within one year of the owner's death. IRC § 72(s).

The Living Trust Problem

If no successor owner provision is available under the contract, some clients might consider transferring ownership of the annuity contract to a living trust during the owner's lifetime. The problem with this approach is the loss of tax deferral on earnings if the contract is not owned by a human being. IRC § 72(u). Generally, the contract should not be put in the owner's living trust during lifetime and, instead, a successor owner provision in the contract should name the trust as successor owner after the owner's death.

Estate Tax Value

As in the life insurance context, the IRS has taken the position by regulation that the value of an annuity is the cost of replacing the annuity at the time of the owner's death. Treas. Reg. § 20.2031-8.

Conclusion

In reviewing estate planning considerations with clients, careful attention must be paid to the provisions of annuity investments to coordinate with the balance of the estate plan. While clients often don't understand the mechanics of the annuity contract, it is the lawyer's responsibility to see that explanations are provided and proper decisions made to produce the client's desired estate planning outcome.

Stephen O. Lane

FROM THE BENCH

Probate As A Specialty

Should all lawyers engage in the practice of probate law? This is a question all practitioners should ask themselves. Consider what you have to offer a client. Consider, also, the level of your expertise as you undertake to meet the court's expectations in the area of probate law.

The practice of probate law is generally nonadversarial and generally one's client is likely to be inexperienced and undemanding. Probate practice is therefore attractive to members of the Bar no matter what their background or experience. The seeming ease of probate administration compared to litigation practice coupled with the assurance of payment of earned fees encourages most practitioners to undertake estate practice even though they know little about the procedure, the complexities and the hazards. The existence of CLE publications, manuals and forms make it appear easy, and it is so convenient to delegate the work to a paralegal or a person less accountable than lawyers themselves.

Beware of the temptation to underestimate the requirements of statute, the expectations of the court and the interests of your client, the fiduciary, and the estate itself. Recognize the importance of taking personal and professional responsibility for all probate work carried on in your offices.

First of all, exercise client control. Explain the responsibilities and the risks that are imposed upon a fiduciary by statute and by the court. Set out rules and safeguards. Retain the checkbook if necessary and direct that monthly bank statements be sent to your office. Do not allow loans to be made to the fiduciary or others. See that commingling of funds does not occur. See that only the fiduciary signs checks and that a spouse, secretary or attorney does not. Demand that records be maintained regularly and accurately. Maintain a tickler system for document preparation and filing deadlines. If you note an irregularity during the accounting preparation, address it in the narrative with a recommendation as to how it should be resolved. Do not wait for the court to discover the problem, and avoid the likelihood of having a hearing scheduled to deal with the problem.

Anticipate the audit of all conservatorship accountings and of annual and final accountings in the probate of decedents' estates. Report accurately as to all assets listed on the inventory, all transactions by narrative explanation, all items of receipts and disbursements with an appropriately detailed explanation. Include supporting documents such as canceled

checks, bank statements and brokers' statements as exhibits properly attached, referenced to the narrative statement in a form which will permit the audit to be conducted with ease and dispatch. Questions about form should be referred to the court clerk or probate commissioner.

Hone your skills by participating in local or state bar groups that are committed to improving the quality of probate practice. Refrain from delegating the important tasks relating to probate administration to others. Review the statutes, Oregon State Bar publications, Oregon Rules of Civil Procedure, Uniform Trial Court Rules, and local court rules, and consult with your local court officials. Some local bar associations provide peer assistance as well as mentorship for those who are willing to accept some coaching.

The duty of a fiduciary to an estate is one of trust. The duty of an attorney to the court in probate matters is to be professional. The practical result of maintaining a high level of trust and professional performance is:

1. Acceptance of documents by the court without delay and without request for revision,

2. An enhanced reputation as a qualified probate practitioner,

3. A satisfied client,

4. Improved economic benefits, and

5. Personal and professional satisfaction.

Judge Pierre L. Van Rysselberghe

Circuit Court Judge

Lane County

WHAT'S NEW

Estate of Bonner, 84 F3d 196 (5th Cir 1996)

Estate of Bonner concerned fractional interest discounts against the value of real and personal property for federal estate tax purposes. Mr. Bonner, the decedent, died owning a 62.5 % undivided interest in one parcel of real property, a 50 % interest in another parcel of property and a 50 % interest in a boat. Mr. Bonner was also the beneficiary of a QTIP trust established by the will of his wife, who died in 1986. The QTIP trust owned the remaining interest in the properties, and was included in Mr. Bonner's estate under IRC § 2044. Mr. Bonner's estate claimed a 45 % fractional discount for the undivided interests owned outright by him at his death.

The Service sought to disallow the discount claimed by the estate by arguing that the undivided interests were merged when they were all included in Mr. Bonner's estate. The Service relied on § 2044 which provides that QTIP property included in a decedent's estate "shall be treated as property passing from the decedent." IRC § 2044(c).

The Fifth Circuit rejected this argument, relying on its prior decision in *Estate of Bright,* 658 F2d 999 (5th Cir 1981) (en banc), which rejected the "doctrine of family attribution." Here, because the assets in the QTIP trust could have been left to any recipient of Mr._Bonner's choosing, the court found no reason to treat the QTIP trust assets as merging with the estate's assets. The estate tax treatment of QTIP property as "passing from the decedent" was considered irrelevant.

Subchapter S Corporation and Other Tax Law Changes

On August 20, 1996, President Clinton signed into law the Small Business Job Protection Act of 1996. The Act adopts a number of tax law changes, including several revisions to subchapter S. The subchapter S changes that are likely to be most significant to most Subchapter S corporations are as follows:

1. For taxable years beginning after 1996, Subchapter S corporations will be allowed to have up to 75 shareholders and may also have as shareholders new electing small business trusts. Certain banks will be permitted to be Subchapter S corporations.

2. For taxable years beginning after 1996, the Subchapter S corporations will be able to own an interest of any size in another corporation, including a wholly owned subsidiary. (Under current law, Subchapter S corporations generally cannot own 80 % or more of another corporation.) Some, but not all, wholly owned subsidiaries will be treated for tax purposes as part of the parent Subchapter S corporation. All other subsidiaries will be taxed as separate C corporations.

3. The Act also gives the Service authority to waive certain invalid elections made for taxable years beginning after 1982 and includes a one-time waiver of the five-year waiting period for re-election with respect to terminations occurring in a taxable year beginning before 1997.

4. For taxable years beginning after 1997, Subchapter S corporations will be allowed to have as shareholders certain charitable organizations.

As noted above, the Act contains numerous tax law changes outside the Subchapter S corporation context. For example, the provision that charitable contributions of appreciated marketable securities to private foundations may be deducted at the fair market value of the contributed property, rather than its basis, has been reinstated for contributions made between July 1, 1996 and May 31, 1997.

Emily V. Karr

CALENDAR OF SEMINARS AND EVENTS

- November 1, 1996 (Sponsored by the Estate Planning and Administration Section of the Oregon State Bar) **Conservatorships and Guardianships: Practice and Judicial Developments After Senate Bill 61** (morning), and Representing Fiduciaries (afternoon), Portland, Oregon. Telephone (800) 452-8260, extn. 413, (503) 684-7413.

- November 7-8, 1996 (Sponsored by the Estate Planning Council of Seattle and the Washington State Bar Association CLE Committee) **Forty First Annual Estate Planning Seminar**, Washington State Convention & Trade Center, Seattle, Washington. Telephone (206) 727-8202.

- November 17-22, 1996 (Sponsored by New York University) **55th Institute on Federal Taxation**, Hotel Del Coronado, San Diego, California. Telephone (212) 998-7171.

- November 18-22, 1996 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, Ritz-Carlton, San Francisco, California. Telephone (800) CLE-NEWS.

- December 5-6, 1996 (Sponsored by ALI-ABA) **Tax Exempt Charitable Organizations**, Embassy Row Hotel, Washington, D.C. Telephone (800) CLE-NEWS.

- December 5-6, 1996 (Sponsored by ALI-ABA) **International Estate Planning**, New York, New York. Telephone (800) CLE-NEWS.

- January 6-10, 1997 (Sponsored by University of Miami School of Law) **31th Annual Philip E. Heckerling Institute on Estate Planning**, Fontainbleau Hilton Resort and Towers, Miami Beach, Florida. Telephone (305) 284-4762.

- January 13-16, 1997 (Sponsored by University of Southern California) **49th Annual Institute on Federal Taxation**, Los Angeles, California. Telephone (213) 740-2646.

- January 18-25, 1997 (Sponsored by National Law Foundation) **1997 Caribbean Tax and Estate Planning Conference**, Palmas Del Mar Resort, Humacao, Puerto Rico. Telephone (302) 656-4757.

- February 20-22, 1997 (Sponsored by ALI-ABA) **Advanced Estate Planning Techniques, Grand Wailea Resort & Spa, Maui, Hawaii. Telephone (800) CLE-NEWS.**

- February 27-1, 1997 (Sponsored by ALI-ABA) **Fundamentals of Pensions, Welfare Plans, and Deferred Compensation**, Charleston, South Carolina. Telephone (800) CLE-NEWS.

- March 19-21, 1997 (Sponsored by ALI-ABA) **Pension, Profit-Sharing, Welfare, and Other Compensation Plans**, Ritz-Carlton, San Francisco, California. Telephone (800) CLE-NEWS.

- April 16-18, 1997 (Sponsored by ALI-ABA) **Basic Estate and Gift Taxation and Planning**, Le Meridien, Coronado, California. Telephone (800) CLE-NEWS.

- May 5-9, 1997 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, The Plaza, New York, New York. Telephone (800) CLE-NEWS.

- May 29-30, 1997 (Sponsored by ALI-ABA) **Charitable Giving Techniques**, Ritz-Carlton, Boston, Massachusetts. Telephone (800) CLE-NEWS.

- June 12-13, 1997 (Sponsored by ALI-ABA) **Conference on Sophisticated Pension and Welfare Plan and Compensation Issues**, Ritz-Carlton Huntington, Pasadena, California. Telephone (800) CLE-NEWS.

- June 15-20, 1997 (Sponsored by ALI-ABA) **Estate Planning in Depth**, University of Wisconsin Law School, Madison, Wisconsin. Telephone (800) CLE-NEWS.

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