newsletter

Oregon Estate Planning and Administration Section Newsletter

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The Use of Conservation Easements in Estate Planning: An Overview

A conservation easement can be a useful tool in the practitioner's value-reduction toolbox. The conservation easement is one of three partial interests in real property that may be deductible as a qualified conservation contribution under § 170(h) of the Internal Revenue Code. Perhaps thought of, if at all, by many practitioners as part of an obscure income tax provision interesting only to environmentalists, conservation easements can be very useful for land-rich clients (both liberal and conservative) motivated to preserve the family lands for their descendants in a primarily undeveloped state. The conservation easement can help achieve that goal not only by directly imposing restrictions on development, but also by lowering the value of the land and the resultant estate taxes, to help ensure that the land will not have to be sold in order to pay estate taxes. The income tax deduction is often the frosting on the cake, rather than the motivating factor inducing the contribution.

What is a Conservation Easement?

A conservation easement is a grant of the right to impose and enforce restrictions on the use of land owned by the donor, transferred to a governmental unit or certain charitable organizations for "conservation purposes," in perpetuity. IRC §170(h)(1).

Only governmental bodies, or charitable organizations organized for conservation purposes, may be donees of conservation easements. Generally, this means organizations with a commitment to protect the conservation purposes of the donation and with the resources to enforce the easement restrictions. Treas Reg §1.170A-14(c)(1). The Nature Conservancy is a prime example, but numerous local "land trusts" may also serve as donees. The organization must be publicly supported; contributions to private foundations do not qualify.

The contribution must meet any of four "conservation purposes" (described in detail below): (1) Public recreation or education; (2) protection of wildlife habitat; (3) preservation of open space; and (4) historic preservation. IRC §170(h)(4)(A). Important, however, is that a deduction for estate or gift tax purposes (although not for income tax purposes) will be allowed even if none of the "conservation purposes" defined in the tax code are met. IRC §2055(f); IRC §2522(d). These sections provide that a deduction for estate or gift tax purposes will be allowed for any transfer of a conservation easement which meets the requirements of IRC

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§170(h), "without regard to paragraph (4)(A) thereof." Paragraph (4)(A) sets forth the four categories of conservation purposes. The Conference Report states that this rule "permits gift or estate tax deductions to be claimed for qualified conservation contributions without regard to whether the contribution satisfies the income tax conservation purpose requirement." TRA of 1986, P.L. 99-514, 99th Cong., 2nd Sess., October 22, 1986.

An income tax deduction is not allowed if the grant of the easement permits uses that are inconsistent with the conservation purpose establishing the basis of the deduction. For example, development on scenic property is not permitted unless the development is limited and sited in such a way as not to interfere with the dominant scenic view. Development will not be permitted on a forested hill adjacent to a national park unless the development will not impair the view from the park. Treas Reg §1.170A-14(f), Example (3).

The easement must be enforceable against the grantor and the grantor's heirs and assigns in perpetuity, which generally means that it must be recorded and does not generate a charitable deduction until recorded. Treas Reg §1.170A-14(g); *Satullo v. Comm.*, TC Memo 1993-614. If the property is subject to a mortgage, no deduction is allowed unless the mortgagee subordinates its rights in the property to the right of the donee to enforce the easement. Treas Reg §1.170A-14(g)(2). This does not mean that the mortgagee cannot recover the full amount owning to it in the event of foreclosure, but it does mean that the property must be sold subject to the easement.

Valuation of Easement

The value of the easement is generally measured by the difference between the value of the property before the easement and the value after the easement. In determining the value of the property before the easement is placed on the property, the valuation must take into account the current use of the property and the likelihood that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use. Treas Reg §1.170A-14(h)(3)(ii). Value is not affected by whether the owner has actually put the property to its highest and best use. *Alvin H. Clemens*, TC Memo 1992-436. If the value of other property of the donor or a related person is enhanced by the grant of the easement (such as by the preservation of a scenic view), the increase in such value offsets the amount of the deduction.

Obviously, the value of the easement is a highly factual determination, and apparently is the subject of IRS scrutiny. The easement must impose some *bona fide*, practical restriction on the use of the land. Where the easement would make no practical difference on the use of the property, the IRS will argue that the easement has little or no value. For example, in a case involving an open space easement on 308 acres of pasture, cropland and woods in Virginia, the IRS argued that the easement restricting development had no effect on value because the highest and best use both before and after the restrictions were imposed on the property was for agricultural purposes. *Chester W. Fannon, Jr.*, TC Memo 86-572. The restrictions imposed by the easement allowed, with the exception of one 38 acre parcel, no subdivision into parcels less than 50 acres, and imposed restrictions on the number and type of structures permitted to be constructed on each parcel in the event of subdivision. The court found that the highest and best use prior to the easement would be subdivision and development; the highest and best use after the easement would be as a "country gentlemen's estate" or for agricultural purposes. The court allowed discounts of 20% to 33% on each of three parcels. In another Virginia "country estate" case which precluded subdivision, the tax court allowed a discount of approximately 31 percent. *Symington v. Comm.*, 87 TC 892, 904 (1986).

In the unlikely event that a substantial record exists of sales of easements comparable to the donated easement, the value of the easement (and the deduction) is determined by the comparables, rather than by applying the "before and after" methodology. Treas Reg §1.170A-14(h)(3).

Conservation Purposes

The term "conservation purposes" is defined in the tax code, and includes four different categories. These are explained in detail in the regulations and are summarized below:

Recreation or Education. An easement may be granted for the use by the general public for recreational or educational purposes. As examples, the regulations provide that an easement preserving land for public use as a nature or hiking trail, or a water area for boating or fishing, will qualify. Treas Reg §1.170A-14(d)(2).

Protection of an Environmental Habitat. An easement to protect fish, wildlife or plant habitat will qualify if the habitat is "significant." Significant habitats and ecosystems include, for example, habitats for rare, endangered or threatened species; natural areas that represent high quality examples of a terrestrial or aquatic community; and natural areas which are included in, or contribute to, the ecological viability of a state or federal park, preserve, or wilderness area. The land need not be untouched by human hands, but the fish, wildlife or plants must exist there in a relatively natural state. Limitations on public access are permissible. Treas Reg §1.170A-14(d)(3).

Preservation of Open Space. To qualify under this category, the easement must be for the scenic enjoyment of the general public or pursuant to a clearly delineated gov-

ernmental policy. The "open space" category is the most regulated of the four permissible categories, perhaps because of the difficulty of defining "scenic" or "governmental policy." It may also be the most useful of the four categories, being something of a "catch-all" provision. The requirements for open spaces easements are discussed in detail below.

Historic Preservation. A deduction is allowed for restrictions on changes to important historic or archeological sites meeting certain federal standards; land and buildings sited within an historic district and considered as contributing to the significance of the district; and land areas that contribute to property listed on the National Register of Historic Places. Some visual public access is required, the degree depending upon the dependence of public benefit on the access. Treas Reg §1.170A-14(d)(5).

Open Space Easements

Open space easements must meet either the "scenic enjoyment" requirement or the "governmental policy" requirement.

Scenic Enjoyment. The regulations provide that preservation of land may be for the scenic enjoyment of the general public if development of the property would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, water body, trail, or historic structure or land area, utilized by the public. "Scenic enjoyment" is determined by applying a facts and circumstances test. Eight subjective factors are set forth in the regulations, among them: compatibility with other land in the area; contrast and variety provided by the visual scene; openness of the land in an urban setting; and (evoking images of Walden Pond) the "harmonious variety of shapes and textures" and relief from urban closeness. Visual, rather than physical, access of the general public is required to satisfy the test.

Governmental Policy. The alternative requirement that preservation of open space be pursuant to a clearly delineated governmental policy is intended to protect the types of property officially identified as worthy of preservation or conservation. A general declaration of conservation goals is inadequate, but neither must the policy identify specific property. Examples include the preservation of a wild and scenic river, the preservation of farmland pursuant to a state program of flood control, or the protection of the scenic, ecological, or historic character of land that is contiguous to existing recreation or conservation sites. A governmental program according preferential tax assessment or preferential zoning for certain property deemed worthy of protection for conservation purposes would constitute the requisite governmental policy. Treas Reg §1.170A-14(d)(4)(iii). Note that a donation of farm land zoned for farming and given a special tax assessment will not qualify unless the donation also yields a significant public benefit, as described below. Treas Reg §1.170A-14(d)(4)(vi)(A).

Significant Public Benefit Requirement. In either type of open space donation, the donation of the easement must yield a significant public benefit. Congress has identified several factors to be considered, such as the uniqueness of the property, the intensity of land development in the area, the consistency of the proposed open space use with public programs for conservation, and the opportunity for the general public to enjoy the use of the property or to appreciate its scenic values. S. Rep. No. 96-1007, *reprinted at* 1980-2 C.B. 599. The regulations list 11 factors. Treas Reg §1.170A-14(d)(4)(iv).

The Senate Report states that the preservation of an ordinary tract of land would not, in and of itself, yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate significant public benefit or the preservation of a unique land area for public enjoyment would yield a significant public benefit. A weedy inner city vacant lot would not qualify, but the preservation of the lot as a downtown garden probably would. In one private letter ruling, apparently involving land on Martha's Vineyard, a tract of land of unspecified size contained a pond of especially scenic quality and was also a nesting area for many species of migrating birds. The pond was visible from the only paved road on the island. Martha's Vineyard had been experiencing rapid growth, and had been designated by the state as a scenic area, and the road fronting the property as a "Special Scenic Road Area." The easement prohibited all development on the land. Under these facts, the IRS ruled that the easement would serve a public benefit. PLR 8652013.

The land area need not be large in order to qualify. The IRS has approved a conservation easement placed on a 3/4 acre parcel, where the parcel was on a developed stretch of coastal highway and offered an important and rare view of the ocean between commercial developments. PLR 8546112.

The IRS has issued several private letter rulings approving restrictive easements placed on farm land, where the farm land was close to residential developments, was bordered by a busy road or highway, and the easement was consistent with county land use goals. PLRs 8422064, 8544036, 8623037 and 8711054. In the last cited ruling, the IRS found a significant public benefit after considering the uniqueness of the property as one of a few large farms remaining undeveloped in the area, the proposed development of a 97 unit townhouse complex across from the property, the current zoning allowance of 80 home sites

on the property, and rapid development occurring in the vicinity of the property.

An open space easement need not restrict all future development. The regulations deny a deduction if the terms of the easement permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental policy. Treas Reg §1.170A-14(d)(4)(v). In PLR 9218071, the IRS approved a reduction where the taxpayer owned a 500 acre tract of coastal land that contained brackish marshes and ponds, a mixed hardwood forest, some cultivated acreage, two residences, a veterinary hospital, and extensive coastal wetlands containing a wide variety of plant and animal life, including an endangered species. The property was in an area of intensive development. The easement allowed the taxpayer to cut timber (but not clear cut) in accordance with a written forest management plan prepared jointly with the donee organization, to maintain and replace the existing structures and roads, to continue farming, and to hunt and fish on the property. It prohibited any new construction or commercial activities, operation of timber harvesting equipment in wetlands, and many other activities that would interfere with the natural state of the land and its quality as a wildlife sanctuary. In several other letter rulings involving farms, cited above, the IRS allowed a deduction for a restrictive easement that would permit a house to be built for a person or family deriving a substantial part of their livelihood from the farm.

Conclusion

A conservation easement offers multiple benefits. It can protect the property from development while preserving some use of the property for the client's heirs, provide the client with a present income tax deduction, and reduce the value of the property for estate tax purposes. The easement can also be employed in conjunction with other methods of value reduction, such as a family limited partnership, for a compounding value reduction effect. For the right client, the conservation easement may be the best tool in the value reduction tool box for reducing estate taxes and preserving the family lands.

Stephen J. Klarquist, LL. M.

Questions, Comments or Suggestions About This Newsletter?

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Ignorance Is Not Bliss —- Beware of Early Dispositions of ISO Stock

A practitioner advising a client planning to make gifts or other dispositions of corporate stock should determine whether the stock was obtained by the client through the exercise of an incentive stock option ("ISO"). If a taxpayer disposes of ISO stock without meeting certain holding period requirements, income recognition may occur that otherwise could have been avoided.

What is an ISO?

An ISO is an option the employer grants to an employee to purchase employer securities. IRC § 422. Among other statutory requirements, the exercise price of the ISO must be no less than the fair market value of the stock at the time the option is granted. The employee recognizes no income when the ISO is granted or when the ISO is exercised; however, the bargain purchase element is included in income for purposes of the alternative minimum tax. On a sale or exchange of the stock which occurs after meeting the statutory holding periods, the employee will recognize capital gain or loss equal to the difference between the amount received on the disposition and the taxpayer's basis in the stock (the exercise price paid).

What is a "Qualifying Disposition"?

In order to realize the income tax benefits of an ISO, the employee cannot dispose of the stock in a "disqualifying disposition" within 2 years after the company grants the ISO or within 1 year after it transfers stock to the employee. IRC § 422(a)(1). These holding periods do not apply to an ISO exercised after the employee's death. IRC § 421(c)(1)(A). A "disqualifying disposition" includes a sale, exchange, gift or transfer of legal title, but does not include a transfer from a decedent to an estate, an exchange to which IRC §§ 354, 355, 356 or 1036 apply, a mere pledge or hypothecation, a transfer by bequest or inheritance, a transfer between spouses, or a transfer incident to divorce. IRC § 424(c). The IRS has ruled that the transfer of ISO stock to an employee's grantor trust is not a disqualifying disposition. PLR 9309027.

If a disqualifying disposition occurs, the employee will recognize compensation income on the bargain purchase element of the ISO exercise, i.e., the difference between the option price paid and the fair market value at the time the option was exercised. This income would be added to any other gain recognized on the disposition.

The following example illustrates the operation of the IRC § 422 rules in the context of a gift. On January 1,

1994, Sparky, an employee of ACME Dynamite Corporation, is granted an ISO by his employer to purchase 100 shares of ACME stock at $50 per share, the current market price of the stock. On June 1, 1995, at which time ACME stock was trading at $75 per share, Sparky exercised his ISO and received 100 ACME shares with a total basis of $5,000 (the exercise price). On February 1, 1996, when the stock price was $100 per share, Sparky made a gift of his 100 ACME shares to his son, Charlie. Because the gift was made before the later of two years from the grant date of the option or one year from the exercise date of the option, Sparky made a "disqualifying disposition." He will recognize $2,500 of compensation (ordinary) income upon the gift, representing the difference between the option's exercise price, $5,000, and the fair market value of the shares as of the date of exercise, $7,500. Charlie will take the stock with a basis of $7,500. If Sparky waited until June 1, 1996 before making the gift, he would have incurred no income tax on the transaction.

PLR 9308021 provides another example of the negative consequences of violating the ISO statutory holding periods. In that ruling, a disqualifying disposition occurred when ISO stock was transferred to a charitable remainder trust prior to the end of the one-year holding period of § 422(a)(1).

Limitation on Income Recognition

A limitation on the application of these rules may mitigate their impact. IRC § 422(c)(2) provides that compensation income recognized on a disqualifying disposition is limited to the amount, if any, by which the amount realized exceeds the employee's adjusted basis in the stock. IRC § 422(c)(2). Again, suppose that Sparky exercised his $50 per share ISO to purchase 100 shares of ACME stock at a time when the stock's fair market value was $75 per share. Prior to the end of the IRC § 422(a)(1) holding periods, Sparky sold the 100 shares of ACME stock to his friend, Bubba, for $60 per share. Sparky must include only $1,000 as compensation income in the taxable year in which the sale occurred (the difference between the amount realized, $6,000, and Sparky's adjusted basis in the shares, the $5,000 exercise price). If Sparky sold the shares to Bubba for $80 per share, the § 422(c)(2) limitation would not apply, and Sparky would recognize $2,500 in ordinary income and a $500 capital gain. Prop. Reg. § 1.422A-1(b)(3), Example 3. If Sparky sold the 100 ACME shares to Bubba for $40 per share, there would be no recognition of income since the amount realized, $4,000, would be less than Sparky's adjusted basis in the shares, the $5,000 exercise price. Sparky would be entitled to a $1,000 capital loss. IRC § 422(c)(2); Prop. Reg. § 1.422A-1(b)(3), Example 5.

The compensation limitation of IRC § 422(c)(2) is inapplicable to a gift or any other transaction in which a loss cannot be recognized, e.g., a related party transaction subject to IRC § 267. Therefore, if, prior to meeting the ISO holding period requirements, Sparky sold the ACME stock to his son, Charlie, for $6,000 or made a gift of those shares, the limitation on income recognition would not apply and Sparky would recognize $2,500 of compensation income (i.e., the difference between the fair market value of the shares at the date of exercise, $7,500, and the $5,000 exercise price). He would recognize no capital gain or loss. Prop. Reg. § 1.422A-1(b)(3), Example 6.

Conclusion

A disqualifying disposition can result in ordinary income treatment for all or part of the gain on a sale or exchange which would otherwise be subject to capital gains rates. The employer may welcome this treatment (because the employer is allowed a deduction for any compensation income recognized by the employee). However, the employee in an income tax bracket above 28% will incur a higher income tax liability on the gain. Also, regardless of the employees' applicable marginal rates, additional tax liability can arise where the limitation of § 422(c)(2) does not apply and the amount realized on a disqualifying sale or exchange is less than the value of the stock when the ISO was exercised. Violation of the ISO stock holding period requirements by making gifts can be particularly costly to the employee who would not otherwise incur income taxation on the transfer. Nonetheless, when taken into account during planning, the pitfalls of the ISO holding periods can usually be avoided with ease.

Peter J. Duffy, LL.M.

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What's New

In re Marriage of Baxter, 139 Or App 32, 911 P2d 343 (1996)

The issues in *Baxter* concerned the enforceability of a premarital agreement. The Oregon Court of Appeals upheld the trial court's finding that the premarital agreement was valid, despite the facts that the agreement was signed immediately before the wedding, the wife was not advised by counsel, the couple never discussed the terms of the agreement, and all copies of the agreement had been destroyed by the time of trial. The only remaining issue was then whether the couple rescinded the agreement by their conduct.

In the early years of their marriage, the appeals court found that Mr. and Mrs. Baxter had conducted their affairs consistently with the presence of the agreement. (Although the terms of the agreement were not discussed in the opinion, and no copy of the agreement then existed, the court appeared to assume that the agreement provided that the parties' separate property at the time of the marriage would remain their separate property in the event of a divorce.) The couple initially had separate full-time employment, had separate bank accounts and did not hold any of Mr. Baxter's business assets jointly. During the course of the marriage, however, Mrs. Baxter left her job and began working in Mr. Baxter's business. Mrs. Baxter also invested her retirement account in the business and co-signed promissory notes for the business. The court of appeals agreed with the trial court that the couple's conduct indicated an intent to rescind the premarital agreement, and therefore it was appropriate to award a portion of Mr. Baxter's business to Mrs. Baxter.

Davis v. Somers, 140 Or App 567, 915 P2d 1047 (1996)

In 1978, Mrs. Mason told her attorney that she wanted plaintiffs to be the residuary beneficiaries under her will. Although the attorney drafted the will accordingly, the residuary clause was inadvertently omitted when the will was typed. Neither the attorney nor Mrs. Mason reviewed the will before it was signed. In 1989, Mrs. Mason met with the attorney, and he discovered the mistake. He attempted to get her to sign a new will rectifying the error, but she was unable to understand the problem and declined to sign the new will. She died in 1990, and the plaintiffs thereafter sued the attorney for negligent preparation of the will.

The Oregon Court of Appeals upheld the trial court's finding that any claim against the attorney was time-barred under ORS 12.115(1). ORS 12.115(1) provides: "In no event shall any action for negligent injury to person or property of another be commenced more than 10 years from the date of the act or omission complained of." The trial court found that the attorney did not have an ongoing duty to ensure that the terms of a will were correct. Therefore, the act or omission occurred in 1978, more than 10 years before the filing of the claim against the attorney.

The plaintiffs argued on appeal that the statute did not apply because they were not injured until Mrs. Mason died and the will became operative. The court of appeals rejected this argument, stating the time the claim accrued was irrelevant to the 10-year ultimate statute of repose. The court relied on its earlier decision involving a premarital agreement, *Withers v. Milbank,* 67 Or App 475, 678 P2d 770 (1984), and rejected the plaintiffs' argument that *Withers* was distinguishable because a premarital agreement was presently effective, unlike a will. The appeals court also rejected the plaintiffs' argument that their cause of action related to rights in an estate and thus was not barred by ORS 12.115. Finally, the appeals court rejected the plaintiffs' argument that their case also sounded in contract. Where a lawyer promises only to use his best efforts in complying with a client's instructions, the claim sounds in negligence.

Emily V. Karr

Herburger v. Herburger, 144 Or App 89, 925 P2d 103 (1996)

Plaintiff appealed a ruling on defendant's motion for summary judgment dismissing plaintiff's claim for undue influence. The Court of Appeals reversed the lower court and remanded the case for further proceedings.

Plaintiff was appointed as conservator for the decedent one month before decedent's death. Plaintiff was decedent's son from his first marriage. Defendant was plaintiff's step-mother, the decedent's second wife. After decedent's death, plaintiff filed a final conservatorship accounting, which included two annuity policies on the inventory. Although the accounting did not list the beneficiaries of those policies, plaintiff knew that defendant was designated as beneficiary of both annuities. No objections were raised either to the accounting or the beneficiary designations. The court approved the accounting, ordered plaintiff to distribute the remaining estate as previously designated by the protected person, and discharged plaintiff upon completion of such distribution.

Within several months, plaintiff brought a separate action claiming that defendant had previously exercised undue influence over the decedent to cause him to change the beneficiary designations on his annuities from plaintiff to defendant. Defendant moved for summary judgment, saying that plaintiff had his chance to litigate the issue in the conservatorship proceeding and was now barred by the

doctrine of "claim preclusion." The trial court agreed; the Court of Appeals did not.

On appeal, the court found that, "when a protected person dies, the conservator's once broad powers are constricted to delivering the will and retaining the estate until the court's order of termination. Likewise, the court's authority is limited to directing the payment of claims...and debts of the conservatorship estate, and *immediately* thereafter ordering the distribution of the assets in the conservator's possession to the successors." (Emphasis in original.) The court observed that, under ORS 126.003 *et seq.*, neither the conservator nor the court possessed the power after the protected person's death to change a beneficiary designation. Because of this fact, plaintiff did not have an adequate opportunity to litigate the issue of undue influence in the conservatorship proceeding and could not be precluded from bringing his claim.

McNeely v. Hiatt, 142 Or App 522, 920 P2d 1150 (1996)

At issue was the court's denial of attorneys' fees to plaintiff-appellant. The case involves a complicated set of facts, which the appellate court only summarized. Plaintiff brought an action *inter alia* to set aside a decedent's will and invalidate a sale of certain property. Plaintiff succeeded at trial. As a result, property that would have passed in one-third shares to decedent's three surviving daughters (including defendant) instead passed one-fourth each to the three daughters and to plaintiff.

On appeal, the court affirmed the decision to set aside the will and undo the sale, but defendant won the concurrent appeal of some separate issues not involved directly in this case. Defendant petitioned for costs on appeal, which the court awarded. Simultaneously, plaintiff petitioned for attorneys' fees, on the basis of the court's equity power to award fees. The court refused to award plaintiff's fees.

Plaintiff sought reconsideration of the fees issue, asserting that the court should award fees where one beneficiary successfully brings suit to benefit other trust beneficiaries. The court, on reconsideration, upheld its earlier ruling denying plaintiff's fees. The court found that, for the court to award fees on this basis, the plaintiff must bring suit at his own expense and *not* for his sole benefit. *See Rogers v. Rogers,* 71 Or App 133, 137, 691 P2d 114 (1984), *rev den* 298 Or 704 (1985). In this case, the only person benefitted was plaintiff. The beneficial interests of all of the other beneficiaries were diminished as a result of plaintiff's action.

Steven W. Moulton

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A number of subcommittees have been established to address issues relevant to the estate planning section. The members of the executive committee would like to encourage the section membership to consider volunteering for any of various projects or subcommittees. If you have always had that burning desire, but never knew how to get involved or who to contact, now is the time. In order to encourage participation of our section members, Richard Kilbride has agreed to determine the volunteer opportunities and coordinate those opportunities with section members. Some of the existing subcommittees are legislative matters, trusts, loss prevention, CLE and newsletter.

If you are interested, please send a letter indicating your area of interest and/or expertise to executive committee member:

Richard Kilbride, Attorney at Law
423 North Coast Hwy.
PO Box 1270
Newport, OR 97365

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- January 6-10, 1997 (Sponsored by University of Miami School of Law) **31st Annual Philip E. Heckerling Institute on Estate Planning**, Fontainbleau Hilton Resort and Towers, Miami Beach, Florida. Telephone (305) 284-4762.
- January 13-15, 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.
- January 31, 1997 (Sponsored by Estate Planning Council of Portland) **26th Annual Estate Planning Seminar,** Oregon Convention Center, Portland, Oregon. Telephone (503) 224-5858.
- February 5-7, 1997, (Sponsored by Intertec Presentations) **8th Annual Conference on Estate Planning and Administration,** Sheriton Palace, San Francisco. Telephone (330) 220-0600.
- 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.
- April 18, 1997 (Sponsored by Oregon Law Institute) **Foundations of Elder Law (a.m.); Advanced Issues for Elder Law Practitioners (p.m.),** Oregon Convention Center, Portland, Oregon. Telephone (503) 243-3326.
- May 5-9, 1997 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, The Plaza, New York, New York. Telephone (800) CLE-NEWS.
- May 13-17, 1997 (Sponsored by American Bar Association) **Real Property, Probate and Trust Seminar,** The Stouffer Mayflower, Washington, D.C. Telephone (312) 988-6233.
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Building Blocks of a Sound Life Insurance Policy

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The primary value of insurance carrier ratings, like those provided by A.M. Best, is to determine the likelihood that a carrier will survive long enough to keep its guaranteed policy promises. Obtaining ratings from outside (i.e., non carrier) services such as Standard and Poor's, Moody's, and Duff and Phelps, costs the carrier time and money and, therefore, suggests a level of commitment to third-party scrutiny.

Many people have been lulled into believing that financial strength equates with sound insurance policies. However, some relatively small companies have issued and continue to issue solid insurance policies, while some major companies (e.g., Prudential, New York Life, Jackson National, Great-West) are facing class action lawsuits by disgruntled customers with failing policies. Contrary to popular opinion, the risk of com-

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The elements inside a cash value, or permanent, life insurance policy are closely integrated, however, and an imbalance in one element of the policy directly affects the entire policy. If the premiums were calculated on a projection of 9% interest crediting performance and the actual performance is 7%, you are likely to have a problem on your hands.

Ample Premiums

As competition between insurance companies has increased over the past 20 years, companies have designed a variety of methods to illustrate lower premiums to insurance buyers. Vanishing premium whole life policies are designed to accumulate sufficient cash value to cover premium costs after the owner's abbreviated premium payment schedule. Universal life allows for lower premiums, vanishing premiums, or both, by projecting high-interest-driven cash value. In addition, whole life policies use dividends based upon interest crediting rates to reduce future premiums or to purchase term insurance.

The primary problem with each of these premium-saver strategies is the difference between expected and actual performance. Slower interest growth means cash value will be lower than expected. As a result, mortality charges, which are calculated on the amount at risk to the carrier (i.e., death benefit minus cash value) will increase and cash values will be further eroded. Before long, the policy may have insufficient cash value to remain solvent. Many insurance consumers who shopped for the lowest premium are left with a lemon of a policy because they did not understand what they were buying.

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Continuing Management

At least every three years the client should review the policy status and request updated policy illustrations, showing current rate projections, from the insurance carrier, to determine whether the policy is projected to last as long as the client needs insurance protection. If the policy is headed for failure, additional premiums invested today will save the client out-of-pocket cash down the road.

We live in an era of constant change, where even the "safe" life insurance products we always took for granted can now fail us. Understanding the building blocks of a sound life insurance policy can help protect your clients from one of those unpleasant surprises that could put a giant crimp in a carefully crafted estate plan.

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The bill would delete ORS 63.621(2), which provides that the LLC will dissolve upon the occurrence of an event (such as death or withdrawal) that terminates the membership of a member. The bill provides that upon the cessation of a member's interest, including cessation by withdrawal, the holder of the former member's interest will be treated as an assignee, except that in the case of a one-member LLC, an assignee would automatically become a member. Voluntary withdrawal would be permitted. Thus, under the state law default rules, the death, bankruptcy or withdrawal of a member will no longer trigger liquidation rights in the remaining members. A member may voluntarily withdraw and will cease to be a member, but the company will not be required to redeem the withdrawing member's interest. The changes are intended to tighten the restrictions on the ability of members to liquidate their interests under state law (although the restrictions can be overridden by agreement). As a result, passage of this bill would arguably make LLCs the entity of choice for family succession planning.

The bill also restructures the state law default rules to meet the perceived intent of most persons doing business under the LLC Act. The current rules are designed in part to ensure that an LLC will be treated as a partnership for federal tax purposes under the old entity classification regulations. The structure of an LLC formed under the current default rules, e.g., as they relate to one-member LLCs or to dissolution of the company, may not meet the expectations of most clients. The proposal attempts to correct this.

The bill also clarifies that "employment" for employment tax purposes does not include services performed by an LLC by a member, including members who are managers.

Stephen J. Klarquist

Practice Tip: Two-Step Gifting Method Still Advisable

Despite AOD 1995-006 (Aug. 7, 1995) the two-step method of making gifts from a revocable living trust ("RLT") is still the safer approach. In AOD 1995-006, the Internal Revenue Service ("IRS") agreed with the Eighth Circuit's decision in *Kisling v. C.I.R.*, 32 F.3d 1222 (8th Cir 1994), stating that the IRS would no longer attempt to include in a deceased grantor's estate the value of a trust distribution directed by the grantor or a guardian to someone other than the grantor as long as the distribution is properly recharacterized as a withdrawal followed by a gift. Before AOD 1995-006, the IRS had long argued that such distributions by a trustee amounted to a release of the grantor's right to revoke part of the trust, causing distributions made within three years of the grantor's death to be included in his or her estate. In light of AOD 1995-006, some estate planning practitioners now advise their clients that distributions from a RLT to someone other than the grantor will be excluded from the deceased grantor's gross estate, as long as the trust agreement gives the grantor the authority to direct trust distributions and does not allow distributions to anyone other than the grantor on the trustee's own initiative. Nevertheless, estate planning practitioners should be cautious in giving this advice, as there is a strong possibility that this issue may be revisited or changed legislatively. Consequently, it is recommended that estate planning practitioners advise their clients to continue using the two-step method—withdrawal of assets from the trust by the grantor followed by a gift from the grantor to the nongrantor recipients—when gifting assets held in a RLT, to ensure that such assets are not included in the decedent grantor's gross estate at his or her death.

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Drafting tax clauses in wills and trusts can be the bane of an estate planner's existence. Drafting them for couples who have children from prior marriages ("blended families") can be even worse. This article discusses the problems created by IRC § 2207A for estate plans of clients with blended families and the possible solutions to those problems.

Under IRC § 2207A, a deceased person's estate is entitled to recover from any person receiving property, "the value of which is includible in the gross estate by reason of [IRC] section 2044," estate tax attributable to that property at the deceased person's highest marginal rate. The recoverable amount of estate tax is determined by subtracting from the total estate tax due the amount of tax that would have been due had the section 2044 property not been included in the gross estate. IRC § 2207A does not apply if the deceased person "otherwise directs by will." Neither IRC § 2207A nor the regulations under it mention a direction by trust; therefore, the will should contain any direction to override IRC § 2207A even if the clients have chosen revocable living trusts as their primary estate planning documents.

IRC § 2207A gives the executor a right of recovery even over a trust of which the executor may not be the trustee. An executor violates his or her fiduciary duty to the beneficiaries under the deceased person's will if the executor does *not* pursue that right. Further, Treas Reg § 20.2207A-1(a)(2) states that the failure of an estate to exercise its right of recovery under IRC § 2207A is treated as a transfer for gift tax purposes from the persons who could have recovered the property (the beneficiaries under the will) to those from whom it could have been recovered (the beneficiaries under the trust holding section 2044 property). In other words, IRC § 2207A cannot simply be ignored on the assumption that the executor and the beneficiaries can "work something out later." (Note, however, that if an estate does not enforce its right to recover under IRC § 2207A, the beneficiary of the estate to whom the recoverable property would have been distributed is *not* a transferor for generation-skipping transfer tax purposes if the trust from which the recovery should have been made was a reverse-QTIP trust. Treas Reg § 26.2652-1(a)(6), Ex. 7.)

To see the effect of this section, assume a husband and wife, each worth $2 million, with a blended family. Each wants to provide for the other during life and wants his or her property to pass outright to his or her children at the surviving spouse's death. A standard estate plan for the couple would provide that, upon the death of the first spouse to die ("decedent"), the amount of the decedent's property that can pass free of estate taxes by applying his or her remaining unified credit under IRC § 2010 ("Unified Credit") passes to a Credit Shelter Trust and the balance passes to a trust qualified to hold terminable interest property under IRC § 2056 ("QTIP Trust"). These trusts benefit the second spouse to die ("survivor") during his or her lifetime, with the remainder passing to the decedent's children. The survivor's property passes at his or her death outright to his or her children.

IRC § 2207A would operate upon this plan as follows: Upon the decedent's death no estate tax is due (assuming a QTIP election is made as to the QTIP Trust). Upon the survivor's death, the value of the QTIP Trust (assume $1.4 million) is includible in his or her gross estate, which would total $3.4 million. The combined federal and state estate tax would be $1,318,000. Of that, $588,000 (the estate tax due on $2 million) would be payable from the survivor's property and the balance ($730,000) from the QTIP Trust. IRC § 2207A gives the survivor, in effect, the power to appoint $142,000 of the QTIP Trust to the survivor's children simply by allowing IRC § 2207A to operate.

This discrepancy probably cannot be solved by overriding IRC § 2207A in the will in favor of statutory apportionment under ORS 116.313, which states that taxes are apportioned "in the proportion that the value of the interest of each person interested in the estate bears to the total value of the interests of all persons interested in the estate." In our hypothetical, the survivor's children have an interest in the survivor's estate of $2 million, whereas the interest of the decedent's children is worth $1.4 million (the value of the QTIP Trust). Under ORS 116.313, the survivor's children pay 2/3.4 of the estate tax (approximately $775,000) and the decedent's children pay the balance of 1.4/3.4 of the total estate tax, or $543,000. The decedent's children share the benefit of the survivor's Unified Credit and previously got the full benefit of the decedent's Unified Credit as beneficiaries of the Credit Shelter Trust. Although ORS 116.343 makes allowances for exemptions, deductions, and credits in apportioning taxes, it may not allow the survivor's Unified Credit to be applied only to property

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To see the effect of this section, assume a husband and wife, each worth $2 million, with a blended family. Each wants to provide for the other during life and wants his or her property to pass outright to his or her children at the surviving spouse's death. A standard estate plan for the couple would provide that, upon the death of the first spouse to die ("decedent"), the amount of the decedent's property that can pass free of estate taxes by applying his or her remaining unified credit under IRC § 2010 ("Unified Credit") passes to a Credit Shelter Trust and the balance passes to a trust qualified to hold terminable interest property under IRC § 2056 ("QTIP Trust"). These trusts benefit the second spouse to die ("survivor") during his or her lifetime, with the remainder passing to the decedent's children. The survivor's property passes at his or her death outright to his or her children.

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passing to the survivor's children, because unlike the marital or charitable deductions the Unified Credit is not attributable to a particular gift. In other words, statutory apportionment would shift the benefit from the survivor's children to the decedent's children.

Three other solutions may be more successful. First, the husband and wife each could create during their lives an irrevocable Credit Shelter Trust for the benefit of the grantor's spouse (whomever that spouse may be from time to time) with a remainder interest passing to the grantor's children. These trusts should be carefully drafted to avoid being "reciprocal" trusts under the holdings in *U.S. v. Est. of Grace*, 395 US 316 (1969), and its progeny. Each spouse would then create a QTIP trust under his or her will with a tax clause that specifically overrides IRC § 2207A in favor of statutory apportionment under ORS 116.313. In addition to curing the estate tax liability imbalance, this solution allows each spouse to leverage his or her Unified Credit by removing $600,000 plus any subsequent appreciation on that amount from his or her estate.

Second, the tax clause could provide that statutory apportionment applies, with the caveat that any benefit from the survivor's Unified Credit be specifically allocated to the property passing to the survivor's children. Such a clause, though conceptually simple, can be difficult to draft.

Third, the tax clause could provide for apportionment by specific formula defined in the instrument. For example, estate taxes could be allocated as follows: the survivor's property is to pay an amount equal to all estate taxes multiplied by a fraction, the numerator of which is the value of the survivor's property reduced by the value of the survivor's property that can pass free of estate tax by applying the survivor's Unified Credit and the denominator of which equals the numerator plus the value of the property of the QTIP Trust. Recovery from the QTIP Trust would be limited to the balance. The formula approach is particularly useful when the estate plan includes substantial specific gifts that are to pass free of estate taxes or large administration expenses that are to be attributed to a particular property. (The formula provided is intended only as a framework, not a finished product; each client will require a slightly different variation on this theme.)

Finally, however, all solutions to this problem are vulnerable. Because estate tax is incurred at the second death, only the tax clause in the survivor's will governs for purposes of overriding IRC § 2207A. However, it is the survivor's children who benefit from the application of that section. By overriding IRC § 2207A in the manner suggested in this article, the surviving spouse is increasing the property passing to the decedent's children by depriving his or her own children. Even a well-intentioned surviving spouse can develop resentment and hostility toward a decedent's children following the decedent's death and may be tempted to undo the type of planning contemplated in this article. Therefore, at the very least, clients who wish to coordinate their estate plans in this fashion should be warned that such planning easily can be undone.

Christopher P. Cline

Qualified Domestic Trust Regulations

Final qualified domestic trust ("QDOT") regulations have been adopted by the Internal Revenue Service ("IRS") regarding the restrictions on the estate and gift tax marital deduction where a surviving spouse is not a citizen of the United States. For a discussion of these restrictions, see generally Roy Pulvers, "The Strange Case of the Alien Spouse," Or Est Plan and Admin Sec Newsl (July 1989).

A marital deduction is generally not available for property passing to a noncitizen spouse unless the property passes by means of or is transferred to a QDOT. IRC §§ 2056(d), 2056A. The final regulations were effective for decedents dying after August 22, 1995 and clarify various issues concerning the creation and maintenance of a QDOT to qualify for the marital deduction. In addition, the IRS also issued revised temporary regulations regarding security requirements applicable to QDOTs. The discussion below highlights some of the significant provisions of the regulations.

Imposition and Amount of Tax

Distributions of QDOT principal to the surviving spouse on account of hardship are exempt from the tax otherwise imposed. IRC § 2056(A)(b)(3)(B); Treas Reg § 20.2056A-5(c)(1). The definition of hardship has been expanded under the final regulations to include distributions to the spouse to address an immediate and substantial financial need relating to the health, maintenance, education, or support of the spouse or of any person the surviving spouse is legally obligated to support. Treas Reg § 20.2056A-5(c)(1).

Retirement Plans

A surviving spouse now has the option of assigning an individual retirement account or other retirement plan to a QDOT or using special procedures under the regulations to avoid a particularly heavy tax burden. If a decedent's individual retirement account or other retirement plan is not assignable, certain requirements must be met to qualify for the marital deduction. Treas Reg § 20.2056A-4(b)(7), (c). If the surviving spouse is eligible for a hardship exemption for all or part of the corpus portion of a nonassignable annuity payment received from a QDOT, then all or a corresponding part of the payment similarly will be exempt from the rollover or tax payment requirements.

Foreign Documents

To accommodate nonresidents who have limited contact with the United States, the regulations now provide that a QDOT may be established by a document executed under the laws of the United States or a foreign jurisdiction. Treas Reg § 20.2056A-2(a). However, the document must direct that the laws of a particular state of the United States or the District of Columbia govern the administration of the trust, and the direction must be effective under applicable law. *Id.*

QDOT Security Rules

As noted above, the IRS also issued revised temporary regulations regarding the special security requirements applicable to QDOTs that were effective as of February 19, 1996. Under the regulations as originally proposed in 1993, if the fair market value of the assets of the QDOT at the date of death exceeds $2 million the trust instrument must require that (1) at least one U.S. trustee be a bank or (2) the U.S. trustee furnish a bond or security to the IRS in an amount equal to 65 percent of the fair market value of the trust corpus, determined as of the decedent's date of death. The proposal further provided that if the fair market value of the QDOT assets is $2 million or less, the QDOT need not meet the bank or bond requirements if the trust instrument instead provides that no more than 35 percent of the fair market value of the trust assets, determined annually, may be invested in real property located outside the United States.

The revised temporary regulations revise some of the original regulations intended to provide flexibility and guidance on the security requirements. The remainder of this discussion highlights some of these revisions.

Bank Trustees

A U.S. branch of a foreign bank may satisfy the bank trustee requirement under the revised temporary regulations, provided that the trust instrument names at least one U.S. trustee to serve as a co-trustee of the QDOT at all times during its administration. Temp Treas Reg § 20.2056A-2T(d)(1)(i)(A). In addition, the regulations provide that if the U.S. trustee is an individual who is a U.S. citizen, the individual must have a tax home in the United States. Temp Treas Reg § 20.2056A-2T(d)(2). Consequently, a U.S. citizen who resides abroad for business purposes would not be able to qualify as a U.S. trustee.

Security Arrangements

The revised regulations specifically authorize letters of credit as a permissible security arrangement in lieu of providing a bank trustee or trustee's bond. The letter of credit may be issued by a U.S. bank or a U.S. branch of a foreign bank. Generally, the bond or letter of credit must be for at least a one-year term and be automatically renewable at the expiration of the term on an annual basis, unless the IRS is notified at least 60 days before the expiration that the security will not be renewed. Treas Reg § 20.2056A-2T(d)(1)(i)(B), (C).

Principal Residence

For purposes of determining whether the $2 million asset threshold is exceeded, the revised regulations permit the value of the surviving spouse's principal residence, up to $600,000, to be excluded. Treas Reg § 20.2056A-2T(d)(1)(iii)(A). That value may also be excluded for purposes of determining the amount of the bond or letter of credit. Treas Reg § 20.2056A-2T(d)(1)(iii)(B). However, the value of the principal residence will continue to be included in determining whether the 35 percent foreign real property threshold has been exceeded with respect to QDOTs with assets of $2 million or less. Treas Reg § 20.2056A-2T(d)(1)(iii)(C). The principal residence exclusion ceases to apply if the property ceases to be used as a principal residence or the residence is sold and the adjusted sales price is not reinvested in another principal residence within 12 months. Treas Reg § 20.2056A -2T(d)(1)(iii)(G).

Asset Threshold

The revised regulations also exclude any indebtedness with respect to the QDOT assets in determining the $2 million asset threshold. Treas Reg § 20.2056A-2T(d)(1)(ii).

Foreign Real Property

For purposes of determining whether more than 35 percent of the fair market value of the assets of a less-than-$2 million QDOT is foreign real property, the temporary regulations provide a look-through rule. Under this rule, all assets owned by either a corporation or partnership in which the QDOT has more than a 20 percent interest are deemed to be owned directly by the QDOT to the extent of its pro rata share of the assets of the corporation or partnership. Temp Treas Reg § 20.2056A-2T(d)(1)(ii)(B), (D). The look-through rule does not apply to QDOTs that post a bond, provide a letter of credit, or utilize a bank trustee.

Personal Property

The original proposed regulations, which would have required that tangible and intangible personal property (including stocks, bonds, and other securities) be located in the United States to qualify for QDOT status, have been deleted from the revised temporary regulations. Because domestic brokerage companies often maintain foreign securities outside the United States to facilitate the sale of the securities, it would have been impossible for QDOTs to comply with the intangible property rule.

Conclusion

The regulations have not fundamentally changed the restrictions on the marital deduction available for property passing to a noncitizen spouse. However, be aware of the changes to the QDOT regulations if you draft gift or estate tax planning documents for spouses of noncitizens.

Emily V. Karr

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New Title Insurance Endorsement Adopted Affecting Living Trusts, LLCs, and FLPs

Effective August 22, 1996, the Insurance Division of the State of Oregon approved a revised title insurance endorsement (OLTA Form 90) entitled a "Substitute Insured Endorsement." This endorsement is desinged to provide continuation of the title coverage under an existing policy upon transfer of the insured party's interest in real property to a living tust of other form of entity.

The original OLTA Form 90, adopted November 10, 1993, extended title coverage to the trustee of a revocable living trust upon transfer from the insured grantor. The endorsement substituted in the trustee as the insured party. In addition, the endorsement eliminated a defence the title insurer might have has against a *bona fide* purchaser for value (BFP"). *See* ORS 93.640(1).

The *new* OLTA Form 90 broadens available coverage, extending coverage not only to trustees of revocable and irrevocable trusts, but also to partnerships, limited partnerships, LLC, or corporations that fall into carefully defined categories.

There appear to be at least two possible drawbacks to the new endorsement. First, the endorsement removed the BFP defence exclusion. Arguably, the title insurer could not assert that the title held by a trustee, for instance, does not cut off the interests of a prior unrecorded interest holder because the trustee is not a BFP. Second, the endorsement would not cover transfers to an entity set up by a parent with one or more children, such as a LLC or family limited partnership. The endorsement specifically requires that the previous insured party is the "sole or all of the partners, members or shareholders." Even if the parent is the sole owner upon formation, this restriction calls into question the effect of subsuquent transfers of entity ownership interests to the parent's decendents for estate planning purposes.

Steven W. Moulton

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The Inadvertent Executor Under Section 2203 of the Internal Revenue Code

Section 2203 of the Internal Revenue Code, which defines the term "executor" for the purposes of the federal estate tax, is an infrequently cited provision. In fact, although § 2203 has been in the Code in its present form for over 70 years, very little ink has been spilled concerning the nooks and crannies of the provision.

There is little at issue under § 2203 when an executor has been appointed by a court. When there is no court-appointed executor of a decedent, however, persons in possession of the decedent's property may find themselves enjoying unexpected powers and shouldering unexpected burdens. The theory of § 2203 appears to stem from the jaded legal tenet, "Possession is nine-tenths of the law." As a result, under the federal estate tax law, possession of a decedent's property can visit upon the possessor certain responsibilities of an appointed executor.

As the use of trusts and other estate planning tools to avoid probate has become more common in recent years, the issue of who qualifies as the executor of an estate for purposes of the Internal Revenue Code has become more significant. Many persons who would never think of themselves as executors may inadvertently become executors for federal estate tax purposes under § 2203 and may find themselves bearing responsibilities that they neither expected nor desired. Accordingly, it should be recognized that in "shepherding" assets from one generation to the next without probate, § 2203 may be used as both a sword and a shield.

"Executor" Under the Internal Revenue Code

Section 2203 originally was changed to its present form as part of the Revenue Act of 1924. Section 2203 defines the term "executor," as used in connection with the federal estate tax regime, to include:

> the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then *any person in actual or constructive possession of any property* of the decedent [emphasis added].

In This Issue

Implicit in § 2203 is the necessity that a federal estate tax return be filed and federal taxes be paid on the transfer of a decedent's wealth. If no executor has been appointed by a court, the "cure" contained in § 2203 is to treat all those who are in possession of a decedent's assets as executors. "Inadvertent executor or executors" bear the responsibilities and enjoy the powers of an intended executor. The scope of these duties and rights, while being quite broad, is also limited.

The Inadvertent Executor

Treasury Regulation § 20.2203-1 reiterates that, in the absence of a person appointed by a court as the executor or administrator of an estate who is qualified and acting within the United States, the term executor, for purposes of the federal estate tax, includes *"any person in actual or constructive possession of any property of the decedent* [emphasis added]." The regulations go on to specify that

> [t]he term "person in actual or constructive possession of any property of the decedent" includes, among others, the decedent's agents and representatives; safe deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country.

Thus, persons who would never think of themselves as executors may inadvertently become executors for federal estate tax purposes under § 2203 because no executor or administrator of an estate was appointed and they are in actual or constructive possession of assets of the decedent. These knowing, unknowing, or even unlawful possessors become inadvertent executors.

The courts have made reference to these unintended representatives of a decedent's estate by several different terms, including: "fictional executor," "not a genuine executor," and "statutory executor." Regardless of the nomenclature applied, the end result is that some, though not all, of the responsibilities and the benefits of being an intended executor are visited upon and available to the inadvertent executor. For example, inadvertent executors must file an estate tax return, Treas Reg § 20.6018-2, are "required to pay the entire estate tax to the extent of the value of the property in [their] possession," Treas Reg § 20-2002-1, and may file a refund claim for taxes paid on that return, *New York Trust Company (Estate of L.F. Wilson) v. United States,* 26 TC 257 (1956).

Of course, one way of shortcircuiting the uncertainty of being an inadvertent executor is to request that the court appoint an "executor" of the decedent. However, the persons who may be caught within the inadvertent executor net are frequently unaware of their unintended status.

Possession of Property of Decedent

Actual Possession

A person is in actual possession of property to the extent she has physical control of it. This definition covers a range of situations in which a person may be in physical possession of a decedent's property such that the possessor could become an inadvertent executor of the decedent with respect to that property. The Treasury Regulations quoted above give several examples of such persons or entities that may be in actual possession of a decedent's property (e.g., "safe deposit companies, warehouse companies, and other custodians" in actual possession of a decedent's property as well as "brokers holding, as collateral, securities belonging to the decedent." (Treas Reg § 20.2203-1)).

Constructive Possession

Constructive possession is a much more difficult concept. Generally, constructive possession "means being in a position to exercise dominion or control over a thing." The classic definition of the term "constructive possession" explains that

> [a] person who, although not in actual possession, knowingly has both the power and the intention at a given time to exercise dominion or control over a thing, either directly or through another person or persons, is then in constructive possession of it. *Black's Law Dictionary* 1163 (6th ed 1990).

The meaning of "constructive" has been heavily litigated in the area of the constructive receipt of income. A cash method taxpayer has constructively received income that has not been "actually reduced to [the] taxpayer's possession" to the extent it has been

> credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that [the taxpayer] could have drawn upon it during the taxable year if notice of intention to withdraw had been given. Treas Reg § 1.451-2(a).

The Tax Court has recognized that such constructive receipt of income requires "essentially unfettered control by the recipient over the date of actual receipt." *Hornung v. Comr.*, 47 TC 428 (1967). Thus, there is no constructive receipt according to the Treasury Regulations "if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." Treas Reg § 1.451-2(a). The essence of the constructive receipt doctrine relating to income has

been that a taxpayer cannot "turn his back on income." The same rationale should apply to prevent a person from "turning his back" on being in possession and, therefore, on being an inadvertent executor.

Applying this analysis to a person in constructive possession of a decedent's property, such person would become an inadvertent executor if the decedent's property has been set aside so the person has the ability freely to acquire actual possession at any time.

Neither the Code nor the Treasury Regulations give any indication as to priority rules for determining the inadvertent executor among actual and constructive possessors of the same assets of a decedent. For example, is the person who is in actual possession of property or is the person who has the legal right to acquire such property the inadvertent executor or are both? This issue arises frequently yet remains unresolved.

Examples of Inadvertent Executors

As previously pointed out, the regulations provide some examples concerning persons in actual or constructive possession of a decedent's property. The courts also have, on occasion, addressed the question of who constitutes an inadvertent executor. The following examples are illustrative only and by no means exhaust the potential scope of the application of § 2203.

Trustees of Revocable Trusts

When no person has been named or appointed as executor of an estate and the decedent leaves property in a revocable trust (in an attempt to avoid probate), the named trustee will be an inadvertent executor to the extent of the property held in trust. *New York Trust Company (Estate of L.F. Wilson) v. United States,* 26 TC 257 (1956).

Surviving Joint Tenants

If all of the assets of the decedent are jointly held with rights of survivorship, the surviving joint owners become inadvertent executors with respect to that property. *Estate of Guida*, 69 TC 811 (1978).

Decedent's Heirs upon Termination of Appointed Executor's Fiduciary Status

After the discharge of an appointed executor by a probate court and notice to the Internal Revenue Service of the termination of the appointed executor's fiduciary status, as required under § 6903, the decedent's heirs may become inadvertent executors. *S.W. O'Brien, Executor*, 40 BTA 280 (1939).

Unlawful Possessors

Even persons in unlawful possession of a decedent's assets can be inadvertent executors. *Deniro v. United States*, 561 F2d 653 (6th Cir 1977).

Executor of Deceased Spouse Who Was Executrix of Another Estate

The appointed executor of a deceased individual's estate is also the inadvertent executor of any estate of which the decedent had been the appointed executor. *Estate of Alice B. Temple*, BTA Memo 1942-215.

Benefits and Burdens of Qualifying as Inadvertent Executor

The cases addressing the status of possessors of a decedent's property as inadvertent executors demonstrate the range of circumstances in which a party may become an inadvertent executor. Basically, it appears that anyone who touches the property, from illegal possessors to fiduciaries to the decedent's heirs, may be executors under § 2203, although the decedent may not have intended such to be the case.

There are both benefits and burdens that derive from being an executor. Inadvertent executors possess many, but not all, of the powers of appointed executors, generally (but not always) limited to the extent of the decedent's property in their actual or constructive possession. It should be noted that certain powers of being an inadvertent executor may be burdensome on unsuspecting parties. For example, although the ability to answer a deficiency notice directed at the estate may be a benefit to an inadvertent executor in some cases, in others it may be an undesirable burden.

The benefits of being an inadvertent executor include:

- the right to sue for an estate tax refund,
- the right to answer a deficiency notice directed at a discharged executor,
- the right to deduct legal expenses for estate ta purposes,
- the right to make elections on behalf of the estate, including the QTIP election, special use valuation election, and other elections, and
- protection from personal liability under IRC § 2204.

The burdens of being an inadvertent executor include:

- the responsibility to file the estate tax return,
- the responsibility to pay any estate tax due, and
- being a proper person to receive a deficiency notice on behalf of the estate.

Conclusion

The trend toward transferring wealth from one generation to the next without probate will continue to bring to the surface inadvertent executor problems. This is mainly because the federal tax regime has been designed so that, in the absence of an appointed executor, the burdens and benefits associated with the estate tax fall or are conferred upon the person in possession of the decedent's property, even if that possession is unlawful.

It is uncertain whether relinquishing immediately the "possession of a decedent's property" will cleanse a person from the responsibilities of being an inadvertent executor. However, an apparent "escape" from the burdens and uncertainties of being an inadvertent executor is to request the court to appoint someone as an executor of the decedent's estate.

It is important to recognize that the likelihood that an unsuspecting and undeserving individual inadvertently will become an executor is on the increase. Accordingly, we should continue to elevate our awareness of the nuances of § 2203 of the Internal Revenue Code to avoid the many hidden minefields that still exist in the landscape.

Joseph J. Hanna, Jr.

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The End of a Beautiful Thing?: The Recent IRS Assault on Valuation Discounts

No estate planning device has garnered as much recent attention as family limited partnerships and limited liability companies ("family-owned entities"). Their popularity arises from the valuation discounts they provide, for federal gift and estate tax purposes, to the assets transferred to them. However, the IRS has recently announced in TAM 9719006 and in an as yet undecided Tax Court case a position with respect to family-owned entities that, if it survives challenge in the courts, could greatly reduce if not eliminate such discounts.

A properly structured family-owned entity provides discounts for the value of the entity's assets. Put simply, the value of an interest in an asset owned outright is greater than that of an interest in a family-owned entity that owns the same asset because a partner or member has much less control over the asset. The types of discounts and the means of obtaining them are well documented, and this article will not discuss them. Congress in 1990 enacted Chapter 14 (IRC §§ 2701-2704) to curtail the availability of certain discounts; IRC § 2704 was designed to reduce taxpayers' ability to obtain discounts through family-owned entities. *See* Stephen J. Klarquist, *Structuring the Family Limited Partnership: Avoid the Traps Laid by Section 2704*, Or Est Plan & Admin Sec Newsl at 1 (OSB Oct. 1996). However, some have argued that the IRS might also use § 2703 to reduce or eliminate those discounts. *See, e.g.,* Jeffrey N. Pennell, *Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice*, U Miami Inst Est Plan ch 9 (1996).

IRC § 2703

IRC § 2703 states that, for transfer tax purposes, "the value of any property shall be determined without regard to * * * any restriction on the right to sell or use the property." Such a right or restriction may be contained in a partnership agreement, articles of incorporation or any other agreement, or it may be implicit in an entity's capital structure, and it applies to all transfers to the natural objects of a donor's bounty. Treas Reg § 25.2703-1(a)(3). Section 2703 applies to any right or restriction created or substantially modified after October 8, 1990. Treas Reg § 25.2703-2. "Substantial modification" is defined in Treas Reg § 25.2703-1(c).

IRC § 2703(b) provides an exception to this valuation rule for any agreement that meets three requirements: (1) it is a bona fide business arrangement; (2) it is not a device to transfer property to members of a decedent's family for less than full and adequate consideration; and (3) its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction. Each requirement must be separately satisfied; proving that a restriction is a bona fide business arrangement is not sufficient to prove that it is not a device to transfer property for less than full and adequate consideration. Treas Reg § 25.2703-1(b)(2). An agreement meets all three requirements if more than 50 percent by value of the property subject to the agreement is owned directly or indirectly (under Treas Reg § 25.2701-6) by individuals who are not members of the transferor's family. Treas Reg § 25.2703-1(b)(3).

IRC § 2703 can be read in either of two ways: (1) it applies to all restrictions contained in an entity's operating agreement on the underlying assets of the entity or (2) it applies only to those restrictions on the transferability of an interest in the entity, just as a buy-sell agreement would. The legislative history provides little guidance. The portion of the Senate Committee Report to the Revenue Reconciliation Act of 1990 (which enacted Chapter 14) dealing with IRC § 2703 is entitled "Buy-Sell Agreements," while the corresponding portion of the Conference Committee Report is entitled "Buy-sell agreements and options," and its only reference to that section is a statement that the provision governing buy-sell agreements was not intended "to disregard such an agreement merely because its terms differ from those used by another similarly situated company." These portions of the legislative history at least infer that § 2703 should apply only to buy-sell agreements. On the other hand, the Senate Committee Report also states that the requirements imposed by § 2703 "apply to any restriction, however created."

The strongest argument against the first interpretation is that it would render § 2704 irrelevant. Under Treas Reg § 25.2704-2(b), any option, right or agreement subject to § 2703 is not subject to IRC § 2704. If "property" under § 2703 is defined as the underlying assets of a family-owned entity and the entity itself is ignored, then § 2704 will never apply. This argument, together with the sparse legislative history, tends to show that § 2703 ought to apply only to interests in a family-owned entity, not to the underlying assets of the entity.

The IRS Interprets IRC § 2703

TAM 9719006 deals with an aggressive estate plan. A decedent who died on March 9, 1994, owned rental real property and marketable securities held in her revocable trust and was the beneficiary of a "Marital Trust" over which she had a general power of appointment. Two days before her death, when she was terminally ill and had been removed from life support, her son and daughter formed a limited partnership to which they each contributed cash in exchange for a 1% general partnership interest. The son as trustee of the Marital Trust contributed $1,700,000 of trust property in exchange for an 82% limited partnership interest, and the son and daughter as trustees of the revocable trust contributed $500,000 of trust property in exchange for a 16% percent limited partnership interest. Immediately after the partnership was formed, the son as trustee of the Marital Trust sold two 30% limited partnership interests to himself and his sister for a small amount of cash and 30-year promissory notes with a 5.06% interest rate.

Two days later, when the decedent died, the revocable trust held a 16% partnership interest, valued on the federal estate tax return at $250,000, and two promissory notes with a total face amount of about $971,000, valued on the estate tax return at $570,000. The Marital Trust held a 22% partnership interest, valued on the estate tax return at $350,000. As a result of the valuation discounts applied to the limited partnership interests and the promissory notes, the estate claimed a "48 percent loss of value (of over $1,000,000) in two-day period."

The IRS developed two alternative positions to deny the application of the discounts to the partnership. First, the formation of the partnership and transfer of partnership interests were a single testamentary transaction and therefore the partnership should be disregarded for valuation purposes. The IRS relied on *Estate of Murphy v. Commissioner*, TC Memo 1990-472, under which a minority discount was denied in the estate of a decedent where that decedent held a minority interest in an asset only as a result of transfers she made 18 days before her death. The decedent's situation in the TAM presented the same kind of fact situation as in *Murphy,* because "the only discernable purpose for the partnership arrangement was to depress the value of the partnership assets" as they passed to the children.

The second position is the more troubling. The IRS held that the transaction was subject to IRC § 2703(a)(2), and, therefore, that the value of the property transferred should be determined without regard to any restriction in the partnership agreement.

The IRS disagreed with the taxpayer's positions that the "property transferred" was the partnership interest, not the underlying partnership property, and that there were no restrictions on the right to sell that interest. Rather, the IRS stated that the property in question was the underlying partnership property and that the partnership agreement imposed restrictions on the sale or use of that property to which § 2703(a)(2) applied. The IRS further ruled that, even if the partnership interest was the subject matter of the transfer, § 2703(a)(2) still would apply, because under the partnership agreement, a transferee of a limited partnership interest became merely an "assignee" and limited partners were prohibited from withdrawing from the partnership or causing it to terminate (common provisions in most family-owned entities). These were restrictions on the limited partner's right to use the partnership interest and they impeded the partner's ability to sell the interest.

The IRS also refused for two reasons to apply the exception under § 2703(b). First, the transactions at issue could not be classified as bona fide, arms length, business arrangements. Second, even if there was a business purpose for the transactions, the limited partnership was formed "primarily (if not exclusively) for the purpose of artificially reducing the value of the decedent's gross estate" and therefore "was a device to transfer property to members of the decedent's family for less than adequate consideration."

Currently before the Tax Court is *Estate of Schauerhamer v. Commissioner*, Docket No. 25058-95, in which the IRS raises an identical argument with respect to the application of IRC § 2703 to a family limited partnership (both the TAM and the IRS opening brief state that a decedent may not cover her assets with a "partnership wrapper," solely to reduce estate taxes). The facts in *Schauerhamer* are not as bad as those in the TAM; however, the decedent in that case did not create the partnership until after she was diagnosed with a terminal illness.

Ramifications of the IRS Position

The transaction in the TAM was aggressive, and the IRS's refusal to respect the form of the transaction is predictable. Applying IRC § 2703, however, was unnecessary and troubling. First, it is unclear from the legislative history whether § 2703 ought to apply at all to partnership agreements. Second, it is not clear whether the IRS properly applied § 2703 to the partnership interest at issue, since it simply denied *all* discounts without using proper appraisal techniques to support its conclusions. Because of the number of family-owned entities that have been created, the IRS will be challenged extensively in court over this application of § 2703.

The IRS's reasoning in the TAM and *Schauerhamer,* if upheld, will have broad ramifications. To avoid the application of IRC § 2703 under that reasoning, a family-owned entity must not be used as a device to transfer property to the natural objects of a transferor's bounty, *whether or not* it has a business purpose. It is doubtful whether any family-owned entity can pass muster under this requirement, since at least one reason for creating these entities is almost always the valuation discounts they generate. The IRS position, if upheld by the courts, could result in the elimination of valuation discounts for family-owned entities altogether.

So what is left to practitioners in this case? There may be two ways to avoid the "device" trap. First, if the estate plan of the client owning an interest in the family LP or LLC passes an interest to anyone other than a "natural object of [her] bounty," then the "device" requirement does not apply. Such may be the case, for instance, if the property passes to someone other than an heir in the event of intestacy (e.g., the client has a spouse but leaves an interest in the entity to a niece instead). *See* John A. Bogdanski, *Federal Tax Valuation* ch 6 (1997). Even if effective, this approach obviously has only limited applicability. Second, the client that has substantial charitable intent should consider giving a 50.1% interest in the family LP or LLC to a public charity (not a private foundation, because of the self-dealing rules under IRC § 4942). The client then could transfer the remaining 49.9% to family members while remaining outside the reach of Chapter 14. The interest in the entity automatically would qualify for the 50% ownership exception to IRC § 2703(a) under § 2703(b). The operating agreement could be drafted as restrictively as possible and still remain outside the reach of IRC § 2704(b), because the consent of a non-family member would be required to alter the agreement. This approach, too, is of only limited usefulness.

Christopher P. Cline

Service Continues Attack on Family Limited Partnerships

The IRS recently issued TAM 9723009, attacking a family limited partnership on three separate alternative positions: (1) disregarding the partnership as a sham, under the authority of *Murphy v. Comm.*, TC Memo 1990-472; (2) applying IRC § 2703 to disregard the entity in determining discounts; and (3) applying § 2704 to disregard restrictions on liquidation in the partnership agreement. A discussion of the Service's first two positions appears in an article in this Newsletter — Christopher P. Cline, *End of a Beautiful Thing?: The Recent IRS Assault on Valuation Discounts* — and will not be repeated here. *See also* John A. Bogdanski, *Family Limited Partnerships: Meet Section 2703,* 24 Est Plan 195 (1997). What's new in TAM 9723009 is the Service's alternative reliance on § 2704.

The new TAM involve the valuation of partnership interests for estate tax purposes. A son, acting for his mother under a durable power of attorney, formed a limited partnership. The son held a 1% interest as a limited partner, his mother held a 98% interest as a limited partner, and a newly formed corporation held a 1% interest as general partner. The son transferred to the limited partnership his mother's property, consisting of cash, marketable securities, two residences, automobiles and other personal property. There was no evidence of a contribution to the partnership by the son or by the corporation. The mother died two months later, at the age of 90. The son was the sole beneficiary under her will.

The partnership had a fixed term. Under local (NY) law, if a partnership agreement does not specify the time or events upon the happening of which a limited partner may withdraw, then the limited partner may withdraw with 6 months' notice.

The corporation, which apparently was unfunded, was owned 65% by the decedent, 34% by the son, and 1% by "Shareholder A." A vote of all shareholders was required (1) to withdraw the corporation as managing general partner and (2) for the corporation, as general partner, to vote to dissolve the partnership or amend the partnership agreement.

The executor of the mother's estate claimed discounts of 46% on the estate tax return for the value of the partnership interests held by the estate.

The IRS made two significant rulings relating to the application of § 2704. First, it apparently ruled that the fixed term in the partnership agreement was in effect an "applicable restriction" and would be disregarded under § 2704. If the fixed term is disregarded, a limited partner can freely withdraw with 6 months' notice. Prior to this TAM, the only information about the Service's position on this issue had been informal comments made by IRS employees.

Second, the IRS held that provisions in the agreement requiring Shareholder A's vote were "illusory, lacked any substance and should not be taken into account for purposes of applying section 2704(b)(2)(B)." It found no evidence of Shareholder A's role, no evidence of his relationship to the other parties, and no evidence of a contribution by A to the corporation. The IRS concluded, "it appears that A was given an interest in Corporation solely to justify any claimed discounts and/or to circumvent the application of setion 2704 by purportedly inserting a non-family member into the consent process." Thus, mother and son could vote to liquidate the entity at any time.

Two comments can be made regarding this ruling. First, recent changes to the Oregon Limited Liability Act (see box below) should make LLCs the entity of choice for family entities (assuming they are not already), avoiding this issue entirely. Second, it is apparent that aggressive, sloppy, last-minute planning will not be respected by the IRS. Nevertheless, the IRS's position with respect to A's participation is troubling. Where will the Service draw the line? If A's participation had even a scintilla of substance, the IRS's position would seem less justified.

Stephen J. Klarquist, LL.M.

LLC Amendments

The Senate passed SB 811, which amends the Oregon Limited Liability Company Act, on July 1. The amendments take advantage of new IRS entity classification rules and clarify the treatment of LLCs for unemployment tax purposes. See the April, 1997 issue of the Newsletter for details. Senate Bill 811 now goes to Governor Kitzaber's office; he is expected to sign the bill.

Income and Estate Taxation of Wrongful Death Proceeds

The personal representative of a decedent may bring a wrongful death action against a wrongdoer for an injury caused by the wrongful act or omission of another. ORS 30.020(1). Recoveries in wrongful death cases include damages of the following kinds: medical and hospital expenses, burial expenses, pain and suffering by the decedent before death, lost income of the decedent and the estate, loss of consortium and punitive damages.
ORS 30.020(2). The income and estate taxation of wrongful death proceeds depends upon the type of damages recovered.

Medical Expenses; Burial Expenses; Pain and Suffering

Income Tax. Not taxable. Generally, all compensatory damages received on account of physical injuries are exempt from income tax, including both medical expenses and damages for pain and suffering. IRC § 104(a)(2); *Commissioner v. Schleier*, 515 US 323, 115 S Ct 2159, 132 L Ed 2d 294 (1995). This general rule applies whether the damages are received pursuant to suit or agreement or as lump sums or periodic payments. Damages for medical, hospital and nursing services are not taxable except to the extent the decedent deducted such expenses under IRC § 213 in a prior year. IRC § 104(a). Expenses paid by a decedent's estate during the one-year period beginning the day after the date of death are treated as paid by the taxpayer at the time incurred and are deductible on his individual tax return, provided a statement is filed waiving the right to take the expense as a deduction on the estate tax return. IRC § 213(c).

Estate Tax. Taxable. Generally, the value of wrongful death proceeds is not includable in a decedent's gross taxable estate. However, where it can be established that such proceeds represent damages to which the decedent had become entitled during her lifetime (such as for pain and suffering and medical expenses) rather than damages for her premature death, the value of these amounts will be includable in the decedent's gross estate. Rev Rul 75-127, 1975-1 CB 297.

Loss of Income

Income Tax. Not taxable. The Ninth Circuit Court of Appeals and the Tax Court have both held that any damages received on account of personal injuries, including lost business income, are excluded from gross income under IRC § 104(a)(2). *Roemer v. Commissioner*, 716 F2d 693 (9th Cir 1983); *Threlkeld v. Commissioner*, 87 TC 1294 (1986). The Tax Court used the example of a young surgeon who loses his finger as a result of the tortious conduct of another. It stated that in such a case the entire damages award, including the portion representing his lost future income, would be excluded from income. *Threlkeld,* 87 TC 1924, 1300 (1986). In *Schleier,* the U.S. Supreme Court cited *Threlkeld* favorably and stated by way of example that damages for lost wages would be excludable under IRC § 104(a)(2).

Estate Tax. Not taxable if for lost post-death earnings; taxable if for pre-death lost wages. Generally, the value of wrongful death proceeds is not includable in a decedent's gross taxable estate. Wrongful death statutes (sometimes referred to as "Lord Campbell" statutes) create a new cause of action in certain relatives of a decedent at the time of the wrongful death. The decedent never has an interest in the cause of action. *Maxwell Trust v. Commissioner,* 58 TC 444, 448 (1972). Because a decedent would have no claim for loss of future income on account of her death, proceeds attributable to this aspect of a wrongful death action are not includable in a decedent's estate for estate tax purposes.

Damages for lost income between the date of the injury and the date of death would be included in the decedent's taxable estate, assuming the decedent had become entitled to recover such damages at the time of her death. Rev Rul 75-127. In this situation the decedent's right to damages would be a property right that passes by virtue of her death, as distinguished from a right that arises after her death. *See Connecticut Bank and Trust Company v. United States*, 465 F2d 760 (2d Cir 1972).

Loss of Consortium

Income Tax. Not taxable. Proceeds in the nature of compensation for loss of life are not generally considered "income." Rev Rul 54-19, 1954-1 CB 179. Damages received by an individual on account of a claim for loss of consortium due to the physical injury of such individual's spouse are excludable from gross income. HR Rep No. 586 at 144, 104th Cong, 2d Sess (1996). Damages for loss of consortium in a wrongful death case should be well within the meaning of "damages for physical injury" and should be excluded from gross income.

Estate Tax. Not taxable. A claim for loss of consortium is not a claim that a decedent could have raised even if she had lived. Damages received on account of loss of consortium are excludable from the decedent's gross estate. *See* Rev Rul 75-127.

Punitive Damages

Income Tax. Taxable. IRC § 104(a)(2), as amended by the Small Business Job Protection Act of 1996, does not apply to punitive damages. Thus all punitive damages in a wrongful death case are includable in the taxable income of the recipient.

Estate Tax. Generally not taxable. The test for taxation, however, is whether the decedent became entitled to punitive damages during his lifetime. Rev Rul 75-127. Thus, if the punitive damages are awarded for the decedent's wrongful death, they are not taxable. If the damages are on account of the pain and suffering of the decedent before death, they are taxable.

Stephen J. Klarquist, LL.M.

Oregon Ethics Opinion 1997-148 Former Client Conflicts: Representation of One Spouse After Joint Estate Planning

Oregon Ethics Opinion 1997-148 outlines the analysis a lawyer must make before representing one spouse (in this case, Wife) in a dissolution proceeding if the attorney previously represented both spouses in joint estate planning. A conflict exists if the dissolution and estate planning are "significantly related." DR 5-105(C) identifies two methods for determining whether matters are significantly related: (1) the matter-specific analysis ("representation of the present client in the subsequent matter would, or would likely, inflict injury or damage upon the former client in connection with any . . . matter in which the lawyer previously represented the former client") or (2) the information-specific analysis ("representation of the former client provided the lawyer with confidences or secrets . . ., the use of which would, or would likely, inflict injury or damage upon the former client in the course of the subsequent matter").

The opinion concludes that a conflict exists where the earlier estate planning was "sufficiently complex that the dissolution will so alter the disposition of assets as to deprive Husband of the benefits of the earlier representation." Much estate planning work, such as drafting wills, creating family trusts, retitling assets to one spouse, orchestrating life insurance and retirement planning, and establishing joint gifting programs would inevitably be altered by the dissolution of a marriage, and the benefits originally provided to the former client by the lawyer would be lost. The Opinion would find a conflict under this scenario. (Query whether there is really anything of an estate planning nature that would not fall into this "inevitably altered" category.)

Even if the dissolution would not deprive the former client of the benefits of the lawyer's earlier work, the lawyer may still have a conflict if the attorney "acquired information from one spouse that is a 'confidence' or 'secret' as to [the] other and that would give the other spouse an unfair advantage in a subsequent dissolution proceeding." The opinion states that no such confidences would be gained where, during the estate planning project, the lawyer always met with both spouses.

If the lawyer concludes that a conflict exists (either because the representation would jeopardize prior work or because the lawyer gained confidences that would be advantageous in the new matter), the lawyer may take the representation only if the current and former clients consent after receiving an explanation sufficient to alert them to the potentially adverse impact of the representation. DR 5-105(D) and 10-101(B).

Shannon M. Connelly

SB 413 Prohibits the Sale of Trusts by a Nonlawyer

Senate Bill 413 as originally introduced would have imposed on trusts the same requirements for valid execution that Oregon law currently applies to wills. The bill required that two witnesses sign the trust instrument, attesting that they saw the trustor sign or heard the trustor acknowledge the trustor's signature. The Department of Justice proposed amendments to SB 413, prohibiting the sale by a nonlawyer of any trust containing dispositive provisions. In the final version of SB 413, the provisions setting forth formalities regarding the execution of trusts are deleted in their entirety. The amendments from the Department of Justice regarding the sale of a trust by a nonlawyer is the bill's sole focus. The current version of SB 413 provides that: "No person shall accept anything of value in exchange for the preparation of a Trust Agreement." The bill does, however, allow an attorney who has formed an attorney/client relationship with the purchaser to accept a fee in exchange for preparation of the Trust Agreement. The bill also amends ORS 646.608 to make violation of SB 413 an unlawful practice under the Unlawful Trade Practices Act.

WHAT'S NEW

***Whisnant v. Whisnant*, 145 Or App 87, 928 P2d 999 (1996)**

The issue raised is whether the decedent, Neill Whisnant, made a gift *causa mortis* to his spouse. The decedent's son and daughter by a prior marriage challenged the trial court's ruling that reasonable minds could not differ on the evidence and that a gift *causa mortis* did occur as a matter of law.

The decedent and his surviving spouse had purchased real property in Hawaii, known as Lot 16, in their joint names, both executing a promissory note secured by a mortgage on the property. Due to a drop in real estate values, the lot was valued significantly less than the mortgage amount immediately thereafter and through the date of death. Under his will, the decedent left the Hawaii property to his spouse. According to testimony, he worried about paying off the mortgage debt and had assured his spouse that if the lot did not sell, he would give it to her free and clear before he died.

Having been diagnosed with inoperable cancers and told he had little time to live, the decedent called his broker to his house and instructed him to sell bonds from his account, with the proceeds to be used to discharge the mortgage. The broker assured the decedent that everything that needed to be done would be done to satisfy the mortgage. The spouse testified that the decedent told her that he was relieved because the mortgage debt had been taken care of for her. Others also testified that the decedent had made statements that he had taken care of the problem with Lot 16.

After the bonds were sold, but before the proceeds were delivered to the decedent's account and before the money was wired to the bank to pay off the loan, the decedent died. The mortgage was paid off subsequent to death.

The court notes that a gift *causa mortis* must be made (1) in anticipation of impending death; (2) with donative intent; (3) with delivery; and (4) with acceptance. Also, the donor must die from the impending peril before the death of the donee.

The plaintiffs argued that the decedent's intent was to pay off the mortgage and not to make a gift to the defendant of the amount of money equal to the payoff balance. The court could see no difference between those two alternatives; the court stated that the satisfaction of a debt may be the subject of a gift to the debtor when done with a requisite donative intent, as the court found in this case. The court pointed out that the decedent wanted to pay off the mortgage for his spouse and he did not want the lot to be a problem for her after his death. Additionally, the court found that delivery to the spouse occurred when the decedent spoke to his broker and told the broker to sell the bonds and pay off the mortgage, believing that everything was done to complete the gift and that he had then given up dominion and control over the assets needed to accomplish his intent.

Therefore, the court found a gift in anticipation of death, with donative intent, and with delivery and acceptance. As far as the decedent was concerned, there was nothing left for him to do to complete the gift, and he had expressed this belief that the matter had been completed to several people.

Timothy R. Strader

***Walker v. Walker*, 145 Or App 144, 929 P2d 316 (1996)**

The decedent, Ralph Walker, partially paralyzed in 1979, executed a will in July 1990. Son, Milton Walker, was not a beneficiary of the will; son, Russell Walker, was the beneficiary. Milton Walker brought a proceeding to contest the validity of Ralph Walker's will. The court addressed the subject of whether the will was validly executed. Attorney Paul Pierson signed the will on behalf of Ralph Walker. Part of the will read that "I, Ralph Walker, execute this instrument as my last will and that I willingly direct Paul Pierson to sign for me . . . ." The will was then signed "s/Ralph Walker" and below that "Ralph Walker, Testator by Paul Pierson (s/Paul Pierson)." The Affidavit of Attesting Witnesses read in part that "he (Ralph Walker) willingly directs Paul Pierson to sign for him . . . ."

Contestant Milton Walker contended that the mandatory formalities of execution under ORS 112.235(2) were not met. The statute provides that "any person who signs the name of the testator . . . shall sign the signer's own name on the will and write on the will that the signer signed the name of the testator at the direction of the testator." Since Pierson did not exactly write those words in that manner, contestant believed that the formalities of execution were lacking and the will was invalid.

The court disagreed. The court recognized that the statute does not prescribe that only the use of the exact statutory language meets the statutory requirements, and interpreted the signing "by Paul Pierson" in the context of provisions of the will and the provisions of the attestation clause to satisfy the statutory requirements.

The court noted that the statute involved in this case is to protect against fraud and stated that there is no question of fraud in the execution of this will. The court concluded that to invalidate the will under these circumstances would be observing the letter of the statute and not giving heed to the statute's obvious purpose.

Timothy R. Strader

***In re Estate of Gollyhorn*, 146 Or App 389, 934 P2d 501 (1997)**

Gollyhorn, an estate heir, filed an objection to the final accounting prepared by the personal representative. The personal representative, who was appearing pro se, had deducted from Gollyhorn's distributive share the value of the personal property Gollyhorn had taken from the decedent's house immediately after death together with the expenses incurred in recovering money improperly paid to Gollyhorn from the estate's accounts. After filing the final account, but before receiving a decree of distribution, the personal representative issued checks to heirs pursuant to the final account. Gollyhorn objected to the deductions made from his distributive share in the final account but did not raise issues of breach of fiduciary duty and of entitlement to attorneys' fees and costs.

The trial court did not enter an order approving the final account and decree of distribution or otherwise closing the estate. However, the trial court found, in a document called "Findings, Order and Money Judgment," that the personal representative breached her fiduciary duties, and the court awarded Gollyhorn a judgment surcharging the personal representative.

The personal representative appealed, and the Oregon Court of Appeals dismissed the appeal. The court of appeals did not reach the merits of the case but found that the decision by the probate court was not appealable. The appeals court held that the "Findings, Order and Money Judgment," despite being called a "judgment," did not conclusively determine the extent and character of the beneficiaries' interest in the estate. Only an order approving the final account and decree of distribution would be appealable, because such an order finally determines the rights and liabilities of all parties to the action. The trial court's decision was an interim order, subject to change. Because the personal representative had not filed documentation concerning payment of taxes, the trial court could not have approved the final account or closed the estate. The dissent stated that because the decision of the trial court included a money judgment for the amount of the surcharge costs and attorneys' fees and provided for interest on the judgment, the decision was appealable like any other money judgment.

Emily V. Karr

***State of Oregon v. Maxine Gjerde* 147 Or App 187, 935 P2d 1224 (1997)**

Appellant Ms. Gjerde sought reversal of an order adjudicating her to be a mentally ill person and committing her to the mental health division. On *de novo* review the Court of Appeals found that the State failed to prove the necessary causal connection between Ms. Gjerde's mental disorder and her determination to return to her home rather than agree to placement in a nursing home. The Court of Appeals reversed the trial court's Order of Commitment.

Ms. Gjerde is described as a feisty, self-reliant 61-year-old woman with a history of heart and lung impairment. Despite her physical impairments she handled her own cooking and shopping, went out for occasional walks, read, listened to music and followed current events. On April 11, 1996, Ms. Gjerde came to Portland Adventist Hospital because she had been experiencing chest pains and had blood in her phlegm. Within a day or two after Ms. Gjerde's admission to the hospital, her treating physician and other medical staff told her that they believed she needed to be placed in a nursing home so that her condition could further stabilize. Ms. Gjerde adamantly refused. Consequently, the hospital's staff psychiatrist filed a notification of mental illness that described Ms. Gjerde as "paranoid and confused and unable to understand the serious nature of her condition." Following the filing of such notification, a civil commitment hearing was held on April 19, 1996. At the commitment hearing, hospital personnel testified about their concerns regarding Ms. Gjerde's adamant refusal to agree to a nursing home placement. The testimony included opinions about Ms. Gjerde's inability to provide for her basic needs and the resulting danger to herself. Ms. Gjerde testified about her independent lifestyle and her perception of her ability to deal with her condition at home.

The Court of Appeals examined the record to determine whether the State had established by clear and convincing evidence that because of a mental disorder Ms. Gjerde was either unable to provide for her basic needs or was a danger to herself. ORS 426.005(1) provides that a mentally ill person means a person who, because of a mental disorder, is either a danger to self or others, or unable to provide for basic personal needs, and is not receiving such care as is necessary for health or safety. The court noted that the statute expressly requires that there be a causal connection between the alleged mental disorder and the danger to self or inability to meet basic needs.

Based upon the above, and upon its review of the record, the Court of Appeals concluded that it is not sufficient for the State to prove that a person has a mental disorder and that the person is dangerous to others, is dangerous to himself or herself or is unable to provide for basic needs. Rather, the State must prove a causal nexus between the mental disorder and at least one of the criteria of ORS 426.005(1). The court found that none of the State's witnesses linked Ms. Gjerde's resistance to a nursing home placement to a mental disorder. Rather, the court found that Ms. Gjerde's testimony evidenced a free, knowing and rational choice to return home, notwithstanding the attendant risk. The court noted that even though such a choice was not necessarily the choice that everyone would make, it was Ms. Gjerde's choice and no one else's. In conclusion, the Court of Appeals stated, "Unless a mental disorder has impaired autonomous choice, civil commitment cannot be a vehicle for 'saving people from themselves.'"

Lisa N. Bertalan

CALENDAR OF SEMINARS AND EVENTS

- July 24-26, 1997 (Sponsored by ALI-ABA and ABA Real Property, Tax Section) **Estate Planning for the Family Business Owner**, Ritz Carlton, Boston, Massachusetts. Telephone (800) CLE-NEWS.

- August 21-23, 1997 (Sponsored by ALI-ABA) **Post Mortem Planning and Estate Administration**, Stanford Court, San Francisco, California. Telephone (800) CLE-NEWS.

- September 4-5, 1997 (Sponsored by ALI-ABA) **Sophisticated Estate Planning Techniques**, Westin Copley Place, Boston, Massachusetts. Telephone (800) CLE-NEWS.

- September 11-12, 1997 and September 25-26, 1997 (Sponsored by Practicing Law Institute (PLI) **28th Annual Estate Planning Institute**. September 11-12 - New York, New York; September 25-26 - San Francisco, California. Telephone (800) 260-4PLI.

- September 16, 18, and 30, 1997 (Sponsored by The Oregon Society of Certified Public Accountants) **The Best Income Tax, Estate Tax and Financial Planning Ideas of 1997**. September 16 - The Eugene Hilton, Eugene, Oregon; September 18 -Windmill's Ashland Hills Inn, Ashland, Oregon; September 30 - OSCPA Center, Beaverton, Oregon. Telephone (800) 255-1470.

- October 10, 1997 (Sponsored by The Oregon Society of Certified Public Accountants) **Today's Hottest Device in Estate Planning: The Family Limited Partnership**, OSCPA Center, Beaverton, Oregon. Telephone (800) 255-1470.

- October 23-25, 1997 (Sponsored by The Southern California Tax & Estate Planning Forum) **The 17th Annual Southern California Tax & Estate Planning Forum & Workshops**, Le Meridien San Diego at Coronado, San Diego, California. Telephone (800) 332-3755.

- October 24, 1997 (Sponsored by CLE, University of Southern California) **23rd Annual Probate and Trust Conference**, Westin Bonaventure Hotel, Los Angeles, California. Telephone (213) 740-2582.

- October 26-31, 1997 (Sponsored by Chaminade University Tax Foundation and the Chaminade University of Honolulu) **34th Annual Hawaii Tax Institute**, Hawaiian Regent Hotel, Waikiki, Hawaii. Telephone (808) 946-2966.

- November 6-7, 1997 (Sponsored by Washington State Bar, Seattle Estate Planning Council) **42nd Annual Estate Planning Seminar**, Washington State Convention & Trade Center, Seattle, Washington. Telephone (206) 727-8200.

- November 17-21, 1997 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates**, Ritz Carlton, San Francisco, California. Telephone (800) CLE-NEWS.

- January 5-9, 1998 (Sponsored by University of Miami School of Law) **Thirty-Second Annual Philip E. Heckerling Institute on Estate Planning**, Miami Beach, Florida. Telephone (305) 284-4762.

- January 12-14, 1998 (Sponsored by University of Southern California) **50th Annual Institute on Federal Taxation**, Beverly Hilton, Los Angeles, California. Telephone (213) 740-2646.

- March 4-6, 1998 (Sponsored by ALI-ABA) **Uses of Insurance in Estate and Tax Planning**, Biltmore Coral Gables, Coral Gables, Florida. Telephone (800) CLE-NEWS.

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newsletter

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Annual Report to Members: Estate Planning and Administration Section

Executive Committee
The Executive Committee met six times during the 1996-97 fiscal year in various locations throughout the state. Activities of the Section were carried out by the Section's subcommittees.

Continuing Legal Education Subcommittee (Cinda Conroyd and Richard Pagnano, Co-Chairs)
The CLE subcommittee presented three seminars in the past year. At the 1996 annual meeting, the Section presented a program entitled "Trust Problems and Litigation." In November 1996, the Section and Bar co-sponsored two half-day programs, "Guardianship/Conservatorship Issues" and "Advising Fiduciaries." In June 1997, the Section and Bar co-sponsored "Tax Basis Issues in Estate Planning." All of the programs were very well attended by the members with consistently high ratings of both the programs and the speakers. The subcommittee is planning a current legislation CLE for the 1997 annual meeting and a program on the taxable estate in November.

Legislative Subcommittee (Ron Bailey and Bernie Vail, Co-Chairs)
The legislative subcommittee worked on the passage of Section-sponsored bills during the 1997 legislative session. Those bills included SB 256 (revising rules on in terrorem clauses in wills and trusts) and SB 255 (amending rules on guardianships and conservatorships). The subcommittee also reviewed and commented on numerous other bills relevant to the section that were introduced during the 1997 legislative session.

Newsletter Subcommittee (Steve Moulton, Chair)
The Section newsletter is published four times annually. Susan Gary serves as Editor-in-Chief and is assisted by a six-person editorial board. The newsletter is designed to keep Section members aware of current issues and developments in estate planning and administration.

In This Issue

Trust Subcommittee (Chris Brown and Jeffrey Thede, Co-Chairs)

The trust subcommittee is currently reviewing rules of construction of wills that should be applied to trusts and other nonprobate transfers at death. The subcommittee plans to have proposed legislation drafted for the next legislative session.

Elder Law Subcommittee (Cinda Conroyd and Wes Fitzwater, Co-Chairs)

The elder law subcommittee has the initial task to review and comment upon legislation and to advise the executive committee on elder law issues.

Loss Prevention Subcommittee (James Berrien, Chair)

The loss prevention subcommittee assists the PLF in identifying practice areas of concern. The subcommittee has updated a probate check list and is reviewing procedures in restricting assets in estates and conservatorships.

Client Security Fund Subcommittee (Rita Batz Cobb, Chair)

The Board of Governors has requested that the Section participate in a review of the issues concerning attorneys serving as fiduciaries.

Advance Directive Subcommittee (Wes Fitzwater, Chair)

The Section has sponsored the production of an educational video that will be available for sale in January 1998. The video is for clients and features a doctor discussing the medical issues associated with the withdrawal of life support.

Respectfully submitted,

Estate Planning and Administration Executive Committee:

Rita Batz Cobb, Chair
Donald Denman, Past Chair
Chris Brown, Chair Elect
David Seulean, Treasurer
Wes Fitzwater, Secretary
James Berrien, Member
Cinda Conroyd, Member
Craig Heath, Member
James Foster, Member
Richard Kilbride, Member
Steven Moulton, Member
Jeffrey Thede, Member
Bernie Vail, Member
Lawrence Rew, BOG Liaison
Sidney Galton, BOG Liaison
Keir Karson, Staff Liaison

1997 Legislation

During the 1997 legislative session, the Oregon legislature enacted a number of bills of significance to estate planners. Following are brief descriptions of the bills that have been signed into law.

SB 206 Provides that a creditor of an intestate decedent may not file a small estate affidavit unless the creditor receives written authorization from the Director of the Division of State Lands.

SB 255 Provides that guardianship and conservatorship proceedings commenced before January 1, 1996, are subject to provisions of ORS chapter 125. Sets forth which notices need to be provided in fiduciary proceedings and provides a form of guardian's report in ORS 125.325. Amends ORS 125.520 by modifying the list of priorities for distribution of funds in a conservatorship.

SB 256 Provides that in terrorem clauses in wills and trusts are valid and enforceable but that such clauses will not be enforced if the devisee or beneficiary contesting the will or trust has probable cause to believe that the will or trust is a forgery or has been revoked, or if the contest is brought by a fiduciary acting on behalf of a protected person.

SB 311 Provides that a person who has elected to defer homestead property taxes under the senior citizen homestead rules can elect to defer taxes retroactively for subsequent years in which the person neglected to file a timely claim for deferral.

SB 413 Adds a new section prohibiting acceptance of anything of value in exchange for the preparation of a trust unless the preparer is an attorney representing a client in the normal course of business or a trust company or financial institution as defined in ORS chapter 706. This section does not apply to resulting trusts, constructive trusts, business trusts, investment trusts, voting trusts, security instruments, trusts created by courts, liquidation

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trusts, employee benefit trusts, escrow trusts, or trusts created by deposits in a financial institution. The act ties trusts to consumer protection laws by amending ORS 646.608 to include violation of this new section as an unlawful trade or business practice.

SB 473 Amends ORS 114.515 to allow a person named as personal representative in decedent's will to file a small estate affidavit.

SB 811 Amends the Oregon Limited Liability Company Act to take advantage of new IRS entity classification rules and to clarify the treatment of LLCs for unemployment tax purposes.

SB 835 Amends ORS 105.630, stating that the surviving tenant of a joint tenancy or tenancy by the entirety may disclaim a present interest by delivering the disclaimer within nine months after the death that caused the interest to vest. Also amends ORS 105.632 to provide that disclaiming a present interest in a joint tenancy or tenancy by the entirety is treated as if the disclaimant had died on the date of death of the person whose death caused the interest to vest.

SB 1034 Removes the prohibition in ORS 128.102 on a provision in a trust agreement that absolves a trustee of liability to the trust estate or to beneficiaries for breach of fiduciary duty or for any tort for which the trustee is personally at fault.

SB 1106 Requires that a lien for long-term care be recorded in each county in which the real property subject to the lien is located, rather than in the county in which the individual who received the care resides. Provides that the lien cannot continue more than ten years. Changes the notice requirements.

HB 2027 Amends ORS 652.190, increasing the amount of wages payable on an employee's death to the employee's surviving spouse or dependent children from $3,000 to $10,000. Defines wages as compensation based on time worked or output of production, or remuneration payable to an individual for personal services.

HB 3207 Permits an individual to direct the disposition of the individual's remains or to delegate the authority to make such decisions using a form in amended ORS 97.130. Expands the list of persons who may direct the disposition of an individual's remains to include the personal representative, the person nominated as personal representative, and a public health officer. Modifies ORS 97.952 with respect to anatomical gifts, permitting an individual to delegate the authority to make an anatomical gift, and expanding the list of persons who may make an anatomical gift of an individual's remains. Provides that an anatomical gift not revoked before death cannot be revised or canceled by others after death.

Estate Planning Changes in the Taxpayer Relief Act of 1997

The Taxpayer Relief Act of 1997 ("Act") is now final, and the Act contains a number of provisions that will affect estate planning practice. This article summarizes the provisions that will most significantly affect estate planning practitioners and provides suggestions for implementing these provisions in clients' estate plans.

Increase in Unified Credit

The current unified credit of $192,800 exempts the first $600,000 of property transfers during life and at death. With respect to decedents dying and gifts made after December 31, 1997, the Act provides for periodic increases in the unified credit, until the applicable exclusion amount reaches $1 million in 2006. The table below shows the increase for each year.

Year	Applicable Exclusion Amount
1998	$625,000
1999	$650,000
2000	$675,000
2001	$675,000
2002	$700,000
2003	$700,000
2004	$850,000
2005	$950,000
2006	$1,000,000

Practice Tip: The increases described above will permit individuals to transfer more property, either during their lives or at death, without incurring gift or estate tax liability, resulting in a potential tax savings of $153,000 in or after 2006 for an estate in excess of $1 million. Practitioners need to be aware, however, that the 5 percent surcharge on estates between $10,000,000 and $21,040,000 has been extended under the Act to provide a recapture of the new increased unified credit amount. As a result, very large estates (i.e. those exceeding $24,100,000) will not benefit from the exemption increase.

Practice Tip: In drafting trust instruments or wills to provide for credit shelter trusts, most practitioners use a formula to ensure that such trusts are funded with the maximum applicable exclusion amount. Alternatively, some practitioners may specifically designate a $600,000 amount. This risky drafting method should not be used, especially now that the applicable exclusion amount will change almost annually. Furthermore, practitioners should review their clients' documents to ensure that any references to a specific dollar amount are eliminated.

As discussed below, the Act provides for annual indexing for inflation with respect to certain estate and gift tax provisions. However, the unified credit amount will not be adjusted for inflation.

Family-Owned Business Exclusion

The Act creates new IRC Section 2033A, which excludes from a decedent's gross estate a certain amount of the value of a qualified family-owned business interest if that interest is left to "qualified heirs." The excluded amount is equal to the difference between $1.3 million and the amount exempted by use of the decedent's unified credit or the "adjusted value" of the qualified family-owned business, whichever is less. Qualified heirs include (1) individuals who have been actively employed by the business for at least ten years before the date of the decedent's death and (2) the decedent's family members. Family members include the decedent's spouse, parents, grandparents, and the following persons and their spouses and ancestors: children, stepchildren, siblings, nieces, and nephews.

To qualify for the family-owned business exclusion, (1) the decedent must be a resident or citizen of the United States at the time of death, (2) the family-owned business interest must comprise more than half of the estate, (3) the business must fall within the definition of "qualified family-owned business interest," and (4) the executor must elect the exclusion and file an agreement signed by each person with an interest in the electing business. A business is "a qualified family-owned business interest" if it is (1) a proprietor's interest in a proprietorship or (2) an interest in an entity owned at least half by the decedent and his or her family, at least 70 percent by two families, or at least 90 percent by three families.

The family-owned business exclusion is subject to several important limitations, such as the exclusion of any interest in a trade or business with a principal place of business outside the United States, interests in publicly traded companies, interests in certain companies subject to personal holding company tax, and interests in businesses attributable to an excessive proportion of marketable securities or certain assets that generate passive income. Additional tax will be imposed if certain triggering events occur within ten years after the decedent's death. Among other things, those events include an heir's failure to materially participate in the business and prohibited transfers.

Practice Tip: The family-owned business exclusion expands the amount of a decedent's assets that can be excluded from his or her gross estate. Although the rules are somewhat technical, they may accommodate many existing family business arrangements, and, with careful planning, many clients' existing business and personal holdings may be restructured to take full advantage of this important exclusion. Practitioners are advised to become thoroughly familiar with these provisions to ensure they are correctly applied.

Charitable Remainder Trusts

To the surprise of many practitioners and charities, Congress included a provision in the Act that requires the value of the charity's remainder interest in any transfer to a charitable remainder trust to be at least 10 percent of the value of the property on the date it was transferred. The effect of this provision is to prevent the use of charitable remainder trusts for persons younger than 35. In addition, the Act limits the maximum payout rate from a charitable remainder trust to 50 percent for transfers in trust after June 18, 1997.

Estate Tax Reduction for Land Subject to Conservation Easement

Up to 40 percent of the value of land subject to a qualified conservation easement granted to a qualified charity can now be excluded from a decedent's gross estate. A maximum of $100,000 may be excluded in 1998, and this amount will increase by $100,000 each year until 2002. In 2002 and thereafter, the maximum excludable amount will be $500,000. To qualify, land must be located in or within 25 miles of a metropolitan area, a national park, a wilderness area, or an urban national forest. In addition, the land must have been owned by the decedent or a member of the decedent's family at all times during the three-year period immediately preceding the decedent's death. A qualified conservation easement is an easement granted to a qualified charity that restricts development rights to preserve habitat, open space, or recreational uses.

This exclusion does not apply to debt-financed property, which is defined in terms much like those contained in the unrelated business income tax rules. In addition, it does not apply to the value of any development right retained by the donor.

Questions, Comments, or Suggestions About This Newsletter?

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Annual Indexing for Inflation

Effective for gifts made and decedents dying after December 31, 1997, the Act provides for annual indexing for inflation of (1) the $10,000 annual gift exclusion, (2) the $750,000 ceiling on special use valuation, (3) the $1 million exemption for generation-skipping transfer tax, and (4) the $1 million ceiling on the value of a closely held business qualifying for the low interest rate on installment payments. As mentioned above, the Act does not provide for annual indexing for inflation with respect to the unified credit.

Installment Payments of Estate Tax Derived from Closely Held Businesses

Currently, IRC Section 6166 permits estate tax attributable to a closely held business to be deferred and paid in installments. The Act reduces the interest rate imposed on the deferred tax in excess of $1 million to 45 percent of the rate applicable to underpayments of tax. The interest rate for the first $1 million of value is fixed at 2 percent. However, interest paid will no longer be deductible.

Uniformity of Rules Governing Trusts and Estates

Several changes will eliminate some of the differences between the rules governing the taxation of trusts and the taxation of estates. These changes include the following:

a. The separate share rule, which formerly applied only to trusts, will now also apply to estates.

b. An estate and its beneficiaries are now treated as related persons, except with respect to a sale or exchange in furtherance of a pecuniary bequest.

c. Upon the executor's election, distributions made during the first 65 days of the estate's taxable year can be treated as having been made during the previous tax year.

Income Tax Provisions That May Affect Estate Planning

Certain provisions of the Act relating to income taxation of individuals may significantly affect estate planning. Among these provisions are the capital gains exemption of up to $500,000 from the sale of a taxpayer's principal residence and the repeal of excess distribution tax and excess accumulation tax.

Under the new law, a married couple may now exempt up to $500,000 ($250,000 for an unmarried individual) of gain derived from the sale of their principal residence. This provision completely replaces the former rollover exemption contained in IRC Section 1034(d) and the former one-time exclusion of gain for persons over age 55, formerly contained in IRC Section 121. To qualify for the exemption, the taxpayers must have lived in the home as their principal residence during at least two of the five years preceding the transfer. The exclusion applies to transfers made on or after May 7, 1997. Transfers made before that date will continue to be governed by the prior rules.

Before the Act, IRC Section 4980A imposed a 15 percent penalty on excess distributions from and on excess accumulations in retirement accounts. The Act repeals Section 4980A.

These changes will remove many of the reasons that previously existed for avoiding excessive accumulations in value in a taxpayer's principal residence and retirement accounts. Under the prior rules, older taxpayers may have chosen to retain their residences to pass at death, to avoid taxation on gain in excess of $125,000, or to pay substantial tax on such gain. Now many individuals will receive the full benefit of the appreciation in value of their residences, and they may move into smaller, less expensive residences and reinvest their gains without penalty. Similarly, while it may have been wise to avoid accumulations in retirement accounts and to accelerate distributions, retirement accounts are now a much more useful planning device.

This article highlights several of the significant changes in tax law effected by the Taxpayer Relief Act of 1997. The Act contains a number of additional provisions that also may affect planning decisions, including provisions relating to the income taxation of trusts and estates. Practitioners are encouraged to become familiar with all of the Act's provisions.

Erik S. Schimmelbusch

Coming Soon - A Doctor's Perspective on the Advance Directive and Withdrawal of Life Support - A Video for Your Clients

What happens to the patient when a ventilator is disconnected or tube feeding is withdrawn? What does "Advanced Progressive Illness" mean? How many times have you said to your clients, "If you have questions about the advance directive, ask your doctor?"

The Estate Planning Section is proud to offer a video for your office that will assist your clients when making end of life decisions. On the videotape, Dr. Susan Tolle, M.D., one of Oregon's leading experts on the withdrawal of life support, discusses these very important decisions and explains medical terminology associated with these issues. Dr. Tolle also describes the symptoms and symptom management associated with the withdrawal of life support. This video will be an invaluable tool for every estate planning and elder law lawyer. The video will be available from the Bar in January 1998.

Making a Difference

As people age, they often have questions about wills, trusts, powers of attorney and probate. Volunteer lawyers offer them access to legal information and assistance on these and other common civil issues through pro bono projects designed specifically for elderly clients. The attorneys provide the advice and representation that the clients need to help preserve their dignity and independence.

The pro bono projects benefit lawyers as well as clients. For example, in Multnomah County's Senior Law Project, a client who is not financially eligible for continued free services may retain the attorney to draft a will or do other work. Some programs sponsor Elder Law Discussion Groups. Others have staff available to consult with volunteers on specialized issues, such as Medicaid eligibility.

These projects need your assistance to respond to the growing elderly population. Please call one of the programs listed below and make the time to make a difference in the lives of older Oregonians.

Multnomah County
Senior Law Project, MBA Volunteer Lawyers Project at Multnomah County Legal Aid Service
(503) 224-4086 or 224-4094

Washington County
Senior Law Project,
Washington County Lawyers Project
Oregon Legal Services
(503) 648-7163

Lane County
Lane County Senior Law Service, Lane Law & Advocacy Center
(503) 342-6056 Ext. 131

Marion & Polk Counties
Marion Polk Legal Aid Service Volunteer Lawyers Project
(503) 581-5265

Elsewhere in Oregon
Oregon Legal Services Regional Offices

Probate Mediation in Marion County

In March 1996, Marion County started a probate mediation program. Megan Hassen, the Alternative Dispute Resolution Coordinator for Marion County, developed the program, with input from me as the probate judge. The process has now been incorporated into Marion County's Supplemental Local Rules.

The Program

The program has two mediation panels: one to mediate disputes regarding guardianships and adoptions (the "people issues panel") and one to mediate disputes regarding estates, conservatorships, and trusts (the "financial issues panel"). To qualify as a court-approved mediator, a person must

- submit an application to the court,
- meet the administrative rule requirements for mediators for court-annexed mediation,
- receive approval by the presiding judge, and
- complete the required legal education seminar.

The panels consist of lawyers, counselors, and social workers, many of whom are also on the panel for domestic relations custody mediation.

Volunteers Sought for New Elder Law Section

The Board of Governors of the Oregon State Bar has been asked to approve a new Elder Law Section. If you would like to participate in the Section's activities, please contact the following individuals:

Agency/professional relations:
Donna Meyer (503) 236-5152
CLE programs:
Heather Gilmore (503) 378-7813
Legislation:
Lisa Bertalan (541) 382-4331
Pro bono/access:
Penny Davis (503) 224-4094
Newsletter:
Michael Levelle (503) 227-1111
Computers:
Margaret Madison Phelan (503) 243-7810

For more information, contact Section chair Valerie Vollmar at (503) 370-6079.

Before the program officially started, I conducted a seminar for each panel. Many prospective mediators were not lawyers, so the seminars included some very basic information about the laws governing the applicable areas. The seminars also addressed likely disputes that arise and possible options for resolving disputes. These seminars were videotaped, and viewing the appropriate tape is a prerequisite for being added to either panel. MCLE credit is available for viewing the tapes.

My process in handling disputes is to hold a status conference before any hearing is set. The parties settle many disputes at this stage. When the parties cannot reach settlement at one or more status conferences, I explain the mediation program and urge people to consider it. When I feel it is appropriate, I give each party an information sheet about mediation and a request for mediation form. If both parties wish to mediate, the case is assigned to a mediator.

The rules give me discretion to assign a matter to mediation on the motion of one party or my own motion. Given the participatory nature of mediation, I am reluctant to assign a case to mediation without agreement of all parties. In a rare case I believe to be suitable, I might assign the case to mediation without full agreement.

Parties who agree to mediate first select a mediator, either anyone they can agree on or someone from the appropriate mediation panel. If the parties cannot agree on a mediator, I will select one from the panel after considering the parties' objections and preferences. The mediator schedules the time and place of the mediation session. The mediator must conduct the mediation in Marion County unless the parties agree otherwise before the first mediation session. More than one session can be set, if the parties and the mediator agree.

Normally, mediation should conclude within 90 days from the order appointing the mediator. I will extend this period to help the parties complete mediation if they request.

Following a settlement, a stipulated order is prepared. A lawyer prepares the order, if a lawyer represents either party. If neither party is represented by a lawyer, the mediator submits an outline of the agreement to the court and I prepare the order.

The parties split the mediator fee of $100 per hour, unless they agree otherwise. Each side pays half of the $500 deposit directly to the mediator within two weeks of the appointment of the mediator. The mediator refunds to the parties any unused deposit after the mediation concludes.

The Track Record

The program sounds great on paper. Nineteen mediators have signed up for the panels, eager to help resolve disputes. Much to my chagrin, parties have used the program in only one case and then unsuccessfully. One other mediation was attempted shortly before the program began, and settlement also was not reached in that case. These failures do not statistically represent the usual level of success of mediation.

I cannot explain why the program has not been used. My guess is that the reasons are fourfold: (1) Many disputes are resolved at status or settlement conference; (2) the cost may be an impediment; (3) sometimes parties are so entrenched in their positions when they get to court that mediation is not a viable option; and (4) many attorneys who practice in the probate area are not yet comfortable with mediation. It is quite possible that I fail to push mediation as much as I could or should.

Future Hope

I continue to hope and expect that mediation will gain popularity in the probate area. Mediation is ideally suited to probate and protective proceedings because so many of the disputes are among family members. Dispute resolution through mediation rather than hearing is far preferable because the chances for repairing the family relationships are better. Mediation in protective proceedings could help avoid future objections by gaining the support of all family members for the protective proceeding.

In violation of the classic rules on writing, I will make my most important point last. **In my opinion, the best use of mediation may be *before* any objection or lawsuit is filed**. At this point, the parties are not as entrenched in their positions as when the court is involved. Also, they have not yet "invested" legal fees for pleadings.

The word is out: Mediate your probate disputes, the sooner in the process, the better.

Jennifer Bellinger Todd
Circuit Court Judge pro tem
Marion County Probate

CALENDAR OF SEMINARS AND EVENTS

- October 15, 1997 (Sponsored by National Law Foundation) **1997 Taxpayer Relief Act and Other Important Estates, Gifts and Trusts Developments,** Marriott Marquis Hotel, New York, New York. Telephone (302) 656-4757.

- October 16, 1997 (Sponsored by National Law Foundation) **Sophisticated Estate Planning & Drafting Techniques,** Marriott Marquis Hotel, New York, New York. Telephone (302) 656-4757.

- October 23-25, 1997 (Sponsored by The Southern California Tax & Estate Planning Forum) **The 17th Annual Southern California Tax & Estate Planning Forum & Workshops,** Le Meridien San Diego at Coronado, San Diego, California. Telephone (800) 332-3755.

- October 24, 1997 (Sponsored by CLE, University of Southern California) **23rd Annual Probate and Trust Conference,** Westin Bonaventure Hotel, Los Angeles, California. Telephone (213) 740-2582.

- October 24, 1997 (Sponsored by Professional Education Systems, Inc.) **Tax Planning & Compliance for Tax-Exempt Organizations.** Telephone (800) 843-7763.

- October 26-31, 1997 (Sponsored by Chaminade University Tax Foundation and the Chaminade University of Honolulu) **34th Annual Hawaii Tax Institute**, Hawaiian Regent Hotel, Waikiki, Hawaii. Telephone (808) 946-2966.

- November 5, 12, and 19, 1997 (Sponsored by ABA-CLE) **The Impact of the 1997 Tax Act on Estate Planning, Administration and Drafting.** November 5 - Los Angeles, California; November 12 - Chicago, Illinois; November 19 - Atlanta, Georgia. Telephone (800) 285-2221.

- November 6-7, 1997 (Sponsored by Washington State Bar, Seattle Estate Planning Council) **42nd Annual Estate Planning Seminar,** Washington State Convention & Trade Center, Seattle, Washington. Telephone (206) 727-8200.

- November 13, 1997 (Sponsored by ABA-CLE) **Effective Estate Planning.** Live from New York, New York, via satellite. For viewing locations, telephone (800) 285-2221 or (312) 988-5522.

- November 17-21, 1997 (Sponsored by ALI-ABA) **Planning Techniques for Large Estates,** Ritz Carlton, San Francisco, California. Telephone (800) CLE-NEWS.

- December 9, 1997 (Sponsored by ABA-CLE) **Strategic Estate Planning for the Family Business Owner.** Live from New York, New York, via satellite. For viewing locations, telephone (800) 285-2221 or (312) 988-5522.

- January 5-9, 1998 (Sponsored by University of Miami School of Law) **Thirty-Second Annual Philip E. Heckerling Institute on Estate Planning,** Fontainebleau Hilton Resort and Towers, Miami Beach, Florida. Telephone (305) 284-4762.

- January 12-14, 1998 (Sponsored by University of Southern California) **50th Annual Institute on Federal Taxation,** Beverly Hilton, Los Angeles, California. Telephone (213) 740-2646.

- January 15, 1998 (Sponsored by ALI-CLE) **Nuts and Bolts of Financial and Retirement Planning.** Live from New York, New York, via satellite. For viewing locations, telephone (800) 285-2221 or (312) 988-5522.

- January 23, 1998 (Sponsored by the Estate Planning Council of Portland Inc.) **27th Annual Estate Planning Seminar,** Oregon Convention Center, Portland, Oregon. Telephone (503) 233-1224.

- January 25-30, 1998 (Sponsored by National Law Foundation) **1998 Mid-Winter Tax & Estate Planning Conference**, Wyndham's Palmas del Mar Resort, Humacao, Puerto Rico. Telephone (302) 656-4757.

- March 4-6, 1998 (Sponsored by ALI-ABA) **Uses of Insurance in Estate and Tax Planning**, Biltmore Coral Gables, Coral Gables, Florida. Telephone (800) CLE-NEWS.

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