Oregon State Bar CLE Seminars

Powering Your Professional Development

Advanced Estate Administration

Cosponsored by the Estate Planning and Administration Section

Friday, June 22, 2012
8:30 a.m.–4:30 p.m.

DoubleTree Hotel
Portland, Oregon

6 General CLE credits and 1 Ethics credit

ADVANCED ESTATE ADMINISTRATION

SECTION PLANNERS

Holly N. Mitchell, *Duffy Kekel LLP, Portland*
Jack V. Rounsefell, *Attorney at Law, Gresham*
Katharine L. West, *Wyse Kadish LLP, Portland*
Eric J. Wieland, *Samuels Yoelin Kantor LLP, Portland*

OREGON STATE BAR ESTATE PLANNING AND ADMINISTRATION SECTION EXECUTIVE COMMITTEE

OREGON STATE BAR
16037 SW Upper Boones Ferry Road
P.O. Box 231935
Tigard, OR 97281-1935

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SCHEDULE

8:00 Registration

8:30 Conflicts of Interest and Confidentiality in Multi-Generational Estate Planning and Administration

- ✦ Prior representation of the decedent or beneficiaries as a source of former client conflicts in estate-related matters
- ✦ Does a trustee or personal representative who is also a beneficiary need two lawyers?
- ✦ Protecting attorney-client privilege when representing a fiduciary

Peter R. Jarvis, *Hinshaw & Culbertson LLP, Portland*

9:30 Planning for Oregon's Elective Share

- ✦ Recent statutory changes
- ✦ Planning ideas to reduce the effects of the changes

William D. Brewer, *Hershner Hunter LLP, Eugene*

10:00 Break

10:15 Asset Protection Basics: Estate Planning and Business Transactions

- ✦ Spendthrift trusts
- ✦ Entity transfer restrictions
- ✦ QTIP income and remainder interests
- ✦ Nonprobate assets

Ian T. Richardson, *Gleaves Swearingen Potter & Scott LLP, Eugene*

11:15 Retirement Plan Designations—Planning for America's Largest Investment Asset

- ✦ Current law
- ✦ How and when retirement plans must be distributed to beneficiaries
- ✦ Deferring tax payments

Ronald A. Shellan, *Miller Nash LLP, Portland*

12:15 Lunch

1:15 New Oregon Estate Tax

- ✦ New tax rates
- ✦ Changes in taxation of nonresidents
- ✦ Effect of lifetime gifts

Philip N. Jones, *Duffy Kekel LLP, Portland*

2:15 Qualified Personal Residence Trusts: Common Situations and Options

- ✦ Creation and funding of QPRTs
- ✦ Tax benefits and potential traps
- ✦ Administering QPRTs
- ✦ Common problems

Amelia E. Heath, *Davis Wright Tremaine LLP, Portland*

3:15 Break

3:30 What's So Special About 2012 Gifting?

- ✦ Fading opportunities for lifetime gifts?
- ✦ GRATs, IDGT/GDOTs, ILITs, and discounts
- ✦ Long-term and lifetime spousal trusts (LST)

Patrick J. Green, *Davis Wright Tremaine LLP, Portland*

4:30 Adjourn

William D. Brewer, *Hershner Hunter LLP, Eugene.* Mr. Brewer is an estate planning partner in the Hershner Hunter law firm. He is a contributing author to the Oregon State Bar publication *Administering Oregon Estates* and to Steve Alberty's treatise, *Advising Small Businesses.* Mr. Brewer is a Fellow of the American College of Trust and Estate Counsel. He served on the Oregon State Bar's Estate Planning and Administration Section Executive Committee for nine years and is a past president of the Eugene Estate Planning Council and past officer of the Lane County Bar's Probate Section.

Patrick J. Green, *Davis Wright Tremaine LLP, Portland.* Mr. Green focuses his practice on wealth, business succession, and estate planning and administration for high–net-worth families and business owners. He also implements complex charitable giving plans, including charitable lead and remainder trusts and donor-advised funds. He is a Fellow of the American College of Trust and Estate Counsel and a member of its Business Planning Committee and State Laws Committee, a Fellow of the American College of Tax Counsel, a member of the American Bar Association, a member of the Multnomah Bar Association, and a member of the Estate Planning Council of Portland. Mr. Green frequently lectures on strategic wealth transfer strategies to professionals throughout the country.

Amelia E. Heath, *Davis Wright Tremaine LLP, Portland.* Ms. Heath is of counsel with the law firm of Davis Wright Tremaine LLP. She provides strategic wealth and business transfer and succession planning strategies for high–net-worth individuals, families, and business owners. She counsels a range of clients in estate planning, charitable gift planning, administration of trusts and estates, and formation of business entities to implement tax and nontax planning. She is a member of the Oregon State Bar Estate Planning and Administration Section Executive Committee and the Estate Planning Council of Portland Seminar Planning Committee. Prior to beginning private practice, she clerked for the Honorable Thomas A. Balmer of the Oregon Supreme Court.

Peter R. Jarvis, *Hinshaw & Culbertson LLP, Portland.* Mr. Jarvis practices primarily in the area of attorney professional responsibility and risk management. He advises lawyers, law firms, and corporate legal departments in legal ethics, risk management, and disciplinary defense matters, and he serves as an expert witness in such matters. He is admitted to practice in Oregon, Washington, California, Alaska, and New York. He is a former board member and past president of the Association of Professional Responsibility Lawyers. Bar committees on which he has served include the Washington State Bar Association's Committee on the Future of the Profession, the Washington State Bar Committee to Define the Practice of Law and the Rules of Professional Conduct Committee, and the Oregon State Bar Legal Ethics Committee. Mr. Jarvis has participated in continuing legal education seminars for law firms and corporate legal departments and numerous public legal ethics/risk management seminars. He has also authored or coauthored many articles and chapters on attorney professional responsibility and risk management issues.

Philip N. Jones, *Duffy Kekel LLP, Portland.* Mr. Jones practices in the areas of estate planning, tax controversies, estate and trust administration and litigation, tax audits and administrative appeals, tax litigation and appeals, and charitable organizations and planned giving. He is admitted to practice in Oregon and Washington and before the United States Supreme Court. He is a member of the American College of Trust and Estate Counsel, the Oregon State Bar Taxation and Estate Planning and Administration sections, the Washington State Bar Association Taxation and Real Property, Probate and Trust sections, and the Estate Planning Council of Portland. Mr. Jones is a frequent speaker and author on estate planning and administration and taxation topics.

Ian T. Richardson, *Gleaves Swearingen Potter & Scott LLP, Eugene.* Mr. Richardson has practiced with Gleaves Swearingen LLP since 1997, focusing on estate planning, business succession planning, and corporate and commercial transactions.

Ronald A. Shellan, *Miller Nash LLP, Portland.* Mr. Shellan is a certified public accountant and has served twice on the board of directors of the Oregon Society of Certified Public Accountants. He is a former chair of the Oregon State Bar Taxation Section. He is also the founding chair of the Portland Tax Forum. He is a frequent speaker before professional groups and at seminars and conferences, including the Northwest Tax Institute and the University of Southern California Tax Institute.

Chapter 1

CONFLICTS OF INTEREST AND CONFIDENTIALITY IN MULTI-GENERATIONAL ESTATE PLANNING AND ADMINISTRATION

Peter R. Jarvis
Hinshaw & Culbertson LLP
Portland, Oregon

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SELECTED OREGON RULES OF PROFESSIONAL CONDUCT

Rule 1.0 Terminology

(a) "Belief" or "believes" denotes that the person involved actually supposes the fact in question to be true. A person's belief may be inferred from circumstances.

(b) "Confirmed in writing," when used in reference to the informed consent of a person, denotes informed consent that is given in writing by the person or a writing that a lawyer promptly transmits to the person confirming an oral informed consent. See paragraph (g) for the definition of "informed consent." If it is not feasible to obtain or transmit the writing at the time the person gives informed consent, then the lawyer must obtain or transmit it within a reasonable time thereafter.

(c) "Electronic communication" includes but is not limited to messages sent to newsgroups, listservs and bulletin boards; messages sent via electronic mail; and real time interactive communications such as conversations in internet chat groups and conference areas and video conferencing.

(d) "Firm" or "law firm" denotes a lawyer or lawyers, including "Of Counsel" lawyers, in a law partnership, professional corporation, sole proprietorship or other association authorized to practice law; or lawyers employed in a private or public legal aid or public defender organization, a legal services organization or the legal department of a corporation or other public or private organization. Any other lawyer, including an office sharer or a lawyer working for or with a firm on a limited basis, is not a member of a firm absent indicia sufficient to establish a de facto law firm among the lawyers involved.

(e) "Fraud" or "fraudulent" denotes conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive.

(f) "Information relating to the representation of a client" denotes both information protected by the attorney-client privilege under applicable law, and other information gained in a current or former professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.

(g) "Informed consent" denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct. When informed consent is required by these Rules to be confirmed in writing or to be given in a writing signed by the client, the lawyer shall give and the writing shall reflect a recommendation that the client seek independent legal advice to determine if consent should be given.

(h) "Knowingly," "known," or "knows" denotes actual knowledge of the fact in question, except that for purposes of determining a lawyer's knowledge of the existence of a conflict of interest, all facts which the lawyer knew, or by the exercise of reasonable care should have known, will be attributed to the lawyer. A person's knowledge may be inferred from circumstances.

(i) "Matter" includes any judicial or other proceeding, application, request for a ruling or other determination, contract, claim, controversy, investigation, charge, accusation, arrest or other particular matter involving a specific party or parties; and any other matter covered by the conflict of interest rules of a government agency.

(j) "Partner" denotes a member of a partnership, a shareholder in a law firm organized as a professional corporation, or a member of an association authorized to practice law.

(k) "Reasonable" or "reasonably" when used in relation to conduct by a lawyer denotes the conduct of a reasonably prudent and competent lawyer.

(l) "Reasonable belief" or "reasonably believes" when used in reference to a lawyer denotes that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable.

(m) "Reasonably should know" when used in reference to a lawyer denotes that a lawyer of reasonable prudence and competence would ascertain the matter in question.

(n) "Screened" denotes the isolation of a lawyer from any participation in a matter through the timely imposition of procedures within a firm that are reasonably adequate under the circumstances to protect information that the isolated lawyer is obligated to protect under these Rules or other law.

(o) "Substantial" when used in reference to degree or extent denotes a material matter of clear and weighty importance.

(p) "Tribunal" denotes a court, an arbitrator in a binding arbitration proceeding or a legislative body, administrative agency or other body acting in an adjudicative capacity. A legislative body, administrative agency or other body acts in an adjudicative capacity when a neutral official, after the presentation of evidence or legal argument by a party or parties, will render a binding legal judgment directly affecting a party's interests in a particular matter.

(q) "Writing" or "written" denotes a tangible or electronic record of a communication or representation, including handwriting, typewriting, printing, photostatting, photography, audio or videorecording and e-mail. A "signed" writing includes an electronic sound, symbol or process attached to or logically associated with a writing and executed or adopted by a person with the intent to sign the writing.

Rule 1.6 Confidentiality of Information

(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to disclose the intention of the lawyer's client to commit a crime and the information necessary to prevent the crime;

(2) to prevent reasonably certain death or substantial bodily harm;

(3) to secure legal advice about the lawyer's compliance with these Rules;

(4) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;

(5) to comply with other law, court order, or as permitted by these Rules; or

(6) to provide the following information in discussions preliminary to the sale of a law practice under Rule 1.17 with respect to each client potentially subject to the transfer: the client's identity; the identities of any adverse parties; the nature and extent of the legal services involved; and fee and payment information. A potential purchasing lawyer shall have the same responsibilities as the selling lawyer to preserve information relating to the representation of such clients whether or not the sale of the practice closes or the client ultimately consents to representation by the purchasing lawyer.

(7) to comply with the terms of a diversion agreement, probation, conditional reinstatement or conditional admission pursuant to BR 2.10, BR 6.2, BR 8.7or Rule for Admission Rule 6.15. A lawyer serving as a monitor of another lawyer on diversion, probation, conditional reinstatement or conditional admission shall have the same responsibilities as the monitored lawyer to preserve information relating to the representation of the monitored lawyer's clients, except to the extent reasonably necessary to carry out the monitoring lawyer's responsibilities under the terms of the diversion, probation, conditional reinstatement or conditional admission and in any proceeding relating thereto.

Rule 1.7 Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a current conflict of interest. A current conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client;

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer; or

(3) the lawyer is related to another lawyer, as parent, child, sibling, spouse or domestic partner, in a matter adverse to a person whom the lawyer knows is represented by the other lawyer in the same matter.

(b) Notwithstanding the existence of a current conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not obligate the lawyer to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client; and

(4) each affected client gives informed consent, confirmed in writing.

Rule 1.8 Conflict of Interest: Current Clients: Specific Rules

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

(1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;

(2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and

(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction.

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, confirmed in writing, except as permitted or required under these Rules.

(c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift, unless the lawyer or other recipient of the gift is related to the client. For

purposes of this paragraph, related persons include a spouse, domestic partner, child, grandchild, parent, grandparent, or other relative or individual with whom the lawyer or the client maintains a close familial relationship.

(d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

(e) While representing a client in connection with contemplated or pending litigation, a lawyer shall not advance or guarantee financial assistance to the lawyer's client, except that a lawyer may advance or guarantee the expenses of litigation, provided the client remains ultimately liable for such expenses to the extent of the client's ability to pay.

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

(1) the client gives informed consent;

(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and

(3) information related to the representation of a client is protected as required by Rule 1.6.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an aggregate agreement as to guilty or nolo contendere pleas, unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims or pleas involved and of the participation of each person in the settlement.

(h) A lawyer shall not:

(1) make an agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement;

(2) settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith;

(3) enter into any agreement with a client regarding arbitration of malpractice claims without informed consent, in a writing signed by the client; or

(4) enter into an agreement with a client or former client limiting or purporting to limit the right of the client or former client to file or to pursue any complaint before the Oregon State Bar.

(i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

(1) acquire a lien authorized by law to secure the lawyer's fee or expenses; and

(2) contract with a client for a reasonable contingent fee in a civil case.

(j) A lawyer shall not have sexual relations with a current client of the lawyer unless a consensual sexual relationship existed between them before the client-lawyer relationship commenced; or have sexual relations with a representative of a current client of the lawyer if the sexual relations would, or would likely, damage or prejudice the client in the representation. For purposes of this rule:

(1) "sexual relations" means sexual intercourse or any touching of the sexual or other intimate parts of a person or causing such person to touch the sexual or other intimate parts of the lawyer for the purpose of arousing or gratifying the sexual desire of either party; and

(2) "lawyer" means any lawyer who assists in the representation of the client, but does not include other firm members who provide no such assistance.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.

Rule 1.9 Duties to Former Clients

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless each affected client gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in the same or a substantially related matter in which a firm with which the lawyer formerly was associated had previously represented a client:

(1) whose interests are materially adverse to that person; and

(2) about whom the lawyer had acquired information protected by Rules 1.6 and 1.9(c) that is material to the matter, unless each affected client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.

(d) For purposes of this rule, matters are "substantially related" if (1) the lawyer's representation of the current client will injure or damage the former client in connection with the same transaction or legal dispute in which the lawyer previously represented the former client; or (2) there is a substantial risk that confidential factual information as would normally have been obtained in the prior representation of the former client would materially advance the current client's position in the subsequent matter.

OREGON FORMAL OPINION NO. 2005-119

FORMAL OPINION NO. 2005-119

Conflicts of Interest, Current Clients: Fiduciaries

Facts:

Plaintiff sues Widow and the estate of Widow's late husband in a personal injury tort action. Widow is the duly appointed personal representative of her late husband's estate. Lawyer *A* has been asked to represent Widow in this litigation, both as an individual and in her capacity as personal representative. The potential liability of Widow and of the estate to Plaintiff could be different, and there are beneficiaries of the estate in addition to Widow whose economic interests may differ from those of Widow.

Employee sues Employer, who is also a trustee of a retirement trust. Employee asserts that Employer has violated the rights of Employee as a beneficiary of the trust. Lawyer *B*, who generally advises Employer with respect to the trust and who advised Employer with respect to the handling of Employee's claim, is asked to represent Employer in the litigation.

Questions:

1. May Lawyer *A* represent Widow both as an individual and in her capacity as personal representative?

2. If, during the course of their professional relationship, Widow informs Lawyer *A* that she has in the past breached the fiduciary duties that she owes to the estate, may Lawyer *A* inform the beneficiaries of the estate of the breaches?

3. If Widow informs Lawyer *A* that she intends to breach such duties in the future, may Lawyer *A* inform the beneficiaries?

4. May Lawyer *B* represent Employer in the trust litigation brought by Employee *B*, in light of the fact that Employee is a beneficiary of the trust?

Conclusions:

1. Yes, but see discussion.

2. No, qualified.

3. Yes, qualified.

4. Yes.

Discussion:

1. *The Estate Questions.*

As we observed in OSB Formal Ethics Op No 2005-62, a lawyer for a personal representative represents the personal representative and not the estate or the beneficiaries. It follows that when Lawyer *A* represents Widow as an individual and Widow in her capacity as personal representative, Lawyer *A* has only one client. Alternatively stated, the fact that Widow may have multiple interests as an individual and as a fiduciary does not mean that Lawyer *A* has more than one client, even if Widow's personal interests may conflict with her obligations as a fiduciary. Representing one person who acts in several different capacities is not the same as representing several different people. Consequently, the current-client conflict rules in Oregon RPC 1.7,[1] do not apply to Lawyer *A*'s situation. *Cf. In re Harrington*, 301 Or 18, 27, 718 P2d 725 (1986).

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[1] Oregon RPC 1.7 provides:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a current conflict of interest. A current conflict of interest exists if:
>
> (1) the representation of one client will be directly adverse to another client;
>
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer; or
>
> (3) the lawyer is related to another lawyer, as parent, child, sibling, spouse or domestic partner, in a matter adverse to a person whom the lawyer knows is represented by the other lawyer in the same matter.
>
> (b) Notwithstanding the existence of a current conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
>
> (2) the representation is not prohibited by law;
>
> (3) the representation does not obligate the lawyer to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client; and
>
> (4) each affected client gives informed consent, confirmed in writing.

The absence of any lawyer-client relationship with the estate or the beneficiaries does not permit Lawyer *A* to assist Widow in any conduct that would be illegal or fraudulent or otherwise in violation of any rule of professional conduct. *See, e.g.*, Oregon RPC 1.2(c) (prohibiting lawyer from counseling or assisting a client "in conduct that the lawyer knows to be illegal or fraudulent"); Oregon RPC 3.1 (prohibiting lawyer from taking any action on behalf of client that has no basis in law or fact); Oregon RPC 8.4(a)(3) (prohibiting lawyer from engaging in "conduct involving dishonesty, fraud, deceit or misrepresentation that reflects adversely on the lawyer's fitness to practice law").[2]

As noted above, Lawyer *A* may not assist Widow in improper conduct. This does not mean, however, that Lawyer *A* is free to reveal information relating to the representation of Widow any more than lawyers for other clients may. Oregon RPC 1.6 provides, in pertinent part:

> (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
>
> (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
>
> (1) to disclose the intention of the lawyer's client to commit a crime and the information necessary to prevent the crime;
>
> (2) to prevent reasonably certain death or substantial bodily harm;
>
> (3) to secure legal advice about the lawyer's compliance with these Rules;

[2] A further clarification also may be appropriate. If Lawyer *A* undertook to represent the beneficiaries and not just the personal representative (as, for example, by giving the beneficiaries individual legal advice about the estate or advising the beneficiaries on other matters), a current client conflict could exist under Oregon RPC 1.7 because Lawyer *A* would then have more than one client. *Cf. The Florida Bar v. Brigman*, 307 So2d 161 (Fla 1975); *Richardson v. State Bar*, 19 Cal2d 707, 122 P2d 889 (1942). *But see Kidney Association of Oregon v. Ferguson*, 315 Or 135, 843 P2d 442 (1992) (theoretical potential for multiple current-client conflict is not automatically a conflict because the two clients—the personal representative of the estate and its sole beneficiary—shared interest in maximizing distribution). See also OSB Formal Ethics Op Nos 2005-85 and 2005-46 regarding the "who is the client" question.

> (4) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;
>
> (5) to comply with other law, court order, or as permitted by these Rules. . . .

On the facts given above, Widow's communication to Lawyer about her past wrongs was made in the course of her representation by Lawyer *A* and thus constitutes information relating to the representation that is protected by Oregon RPC 1.6. It follows that unless one of the exceptions to Oregon RPC 1.6 applies, Lawyer *A* must not reveal Widow's past wrongs. Lawyer *A* may, however, discuss with Widow the legal consequences of her misconduct and counsel her about appropriate corrective measures. Oregon RPC 1.2(c). Lawyer cannot assist Widow in withholding or misrepresenting information she must disclose to the probate court. Oregon RPC 1.2(b), 3.3(a)–(b). In fact, Lawyer would be obligated to seek leave to withdraw if not withdrawing would cause Lawyer to become directly involved in wrongdoing. *See, e.g.*, Oregon RPC 1.16(a).[3] *Cf.* OSB Formal Ethics Op No 2005-53. In withdrawing, however, Lawyer cannot disclose Widow's past wrong or other information protected by Oregon RPC 1.6.

The result would be somewhat different if Widow's statements were not simply communications about past wrongs, but also communications of an intention to commit a future crime. *See, e.g.*, Oregon RPC 1.6(b)(1); OEC 503(4)(a). Lawyer could then ethically disclose the intention of Widow to commit the crime and the information necessary to prevent it. *Cf. State v. Phelps*, 24 Or App 329, 545 P2d 901 (1976). *See also United States v. Zolin*, 905 F2d 1344 (9th Cir 1990); *State v. Belva Ray*, 36 Or App 367, 584 P2d 362 (1978); *State ex rel N. Pacific Lbr. v. Unis*, 282 Or 457, 579 P2d 1291 (1978). As an ethics matter, however, disclosure in this case would be permissive rather than mandatory. OSB Formal Ethics Op No 2005-34.

2. *The Trust Question.*

As discussed above in connection with representation of a personal representative, the lawyer for a trustee represents the trustee and not the trust or its beneficiaries. If the rule were otherwise, it would in effect be impossible for a trustee to obtain legal advice independent of the

[3] With regard to further handling of the matter if the court refuses to allow withdrawal, see OSB Formal Ethics Op No 2005-34.

beneficiaries. Although there is some limited case law to the contrary from other jurisdictions,[4] we do not believe that these cases are either well-reasoned or consistent with the Oregon approach to representation of fiduciaries. *Cf.* Oregon RPC 1.13(a) ("a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents").

Here, too, the fact that Lawyer *B* does not represent the trust beneficiaries does not permit Lawyer *B* to assist Employer in any wrongdoing. *Cf. Whitfield v. Tomasso*, 682 F Supp 1287 (EDNY 1988). Similarly, if the corporate employer and fiduciary were not the same or if Lawyer *B* also represented the beneficiaries as clients, a conflict of interest under Oregon RPC 1.7 could conceivably exist. *Cf. Intern. Union v. Allis-Chalmers Corp.*, 447 F Supp 766, 770–771 (ED Wis 1978) (declining, on facts before court, to find conflict in simultaneous representation of employer and trustee, who were separate entities).

Approved by Board of Governors, August 2005.

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[4] *Cf. Hechenberger v. Western Elec. Co.*, 570 F Supp 820, 823 (ED Mo 1983), *aff'd on other grounds*, 742 F2d 453 (8th Cir 1984); *Helt v. Metropolitan Dist. Com'n*, 113 FRD 7, 9 (D Conn 1986); *Washington-Baltimore v. Washington Star Co.*, 543 F Supp 906, 909 (DC Cir 1982).

COMMENT: For additional information on this general topic and other related subjects, see THE ETHICAL OREGON LAWYER §§4.1–4.11, 4.14, 4.18, 6.1–6.5, 6.12, 7.39, 9.1–9.2, 9.7–9.11, 9.18, 9.20–9.21 (Oregon CLE 2003); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§32–33, 121, 128, 130 (2003); and ABA Model Rules 1.2(d), 1.6–1.7, 1.16, 8.4(c). *See also* Washington Informal Ethics Op Nos 1226, 1849 (unpublished).

ABA FORMAL OPINION 05-434—LAWYER RETAINED BY TESTATOR TO DISINHERIT BENEFICIARY THAT LAWYER REPRESENTS ON UNRELATED MATTERS[1]

AMERICAN BAR ASSOCIATION
STANDING COMMITTEE ON ETHICS AND PROFESSIONAL RESPONSIBILITY

Formal Opinion 05-434 **December 8, 2004**

Lawyer Retained by Testator to Disinherit Beneficiary that Lawyer Represents on Unrelated Matters

There ordinarily is no conflict of interest when a lawyer is engaged by a testator to disinherit a beneficiary whom the lawyer represents on unrelated matters, unless doing so would violate a legal obligation of the testator to the beneficiary, or unless there is a significant risk that the lawyer's representation of the testator will be materially limited by the lawyer's responsibilities to the beneficiary.

This opinion addresses whether, under the Model Rules of Professional Conduct,[1] there is a conflict of interest if a lawyer is retained by a testator[2] to prepare instruments disinheriting[3] a beneficiary whom the lawyer represents on unrelated matters.[4]

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1. This opinion is based on the Model Rules of Professional Conduct as amended by the ABA House of Delegates in August 2003 and, to the extent indicated, the predecessor Model Code of Professional Responsibility of the American Bar Association. The laws, court rules, regulations, rules of professional responsibility, and opinions promulgated in the individual jurisdictions control.

2. The analysis and conclusions of this opinion also apply to a lawyer retained by a grantor to amend a revocable trust so as to reduce or eliminate beneficial interests created in an existing trust instrument.

3. As used in this opinion, "disinherit" means to make a disposition that adversely affects a prospective beneficiary's expectancy under an existing instrument. The effect may be indirect. For example, if the lawyer's other client is a residuary beneficiary, a new provision making specific bequests that deplete the residue of the estate would have an adverse effect on the prospective beneficiary. The conclusions expressed in this opinion also would apply to the circumstance in which the lawyer assists a testator in preparing an instrument that fails to make a bequest to another client the lawyer represents (in unrelated matters) who is a person who would be considered a natural object of the testator's bounty, such as a child or spouse, or who is a person that would, if there were no testamentary disposition, take under the laws of intestate succession.

4. See also ABA Comm. on Ethics and Professional Responsibility Formal Op. 02-428 (Aug. 9, 2002) (Drafting Will on Recommendation of Potential Beneficiary Who Also is Client) (discussing conflicts issues when the beneficiary has recommended the lawyer or pays the lawyer's fee).

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Except as provided in Rule 1.7(b),[5] a lawyer may not represent a client if the representation involves a concurrent conflict of interest. There is a concurrent conflict of interest if either (a) the representation of one client will be "directly adverse" to another client,[6] or (b) there is a significant risk that the representation of one client will be "materially limited" by the lawyer's responsibilities to another client.[7] We consider the extent to which these provisions impact the issue here being addressed.

Direct adverseness requires a conflict as to the legal rights and duties of the clients, not merely conflicting economic interests.[8] There may be direct adverseness even though there is no overt confrontation between the clients, as, for example, where one client seeks the lawyer's advice as to his legal rights against another client whom the lawyer represents on a wholly unrelated matter. Thus, for example, a lawyer would be precluded by Rule 1.7(a) from advising a client as to his rights under a contract with another client of the lawyer, or as to whether the statute of limitations has run on potential claims against, or by, another client of the lawyer. Such conflict involves the legal rights and duties of the two clients vis-à-vis one another.

Applying this analysis to the circumstances dealt with in this opinion, a testator is, unless limited by contractual or quasi-contractual obligations[9] or by state law,[10]

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5. Notwithstanding the existence of a concurrent conflict, a lawyer may represent a client if "the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client, the representation is not prohibited by law, and each affected client gives informed consent, confirmed in writing." Rules 1.7(b)(1), (2), and (4).

6. Rule 1.7(a)(1).

7. Rule 1.7(a)(2). There is a concurrent conflict under Rule 1.7(a)(2) if there is a significant risk that the lawyer's representation will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person, or by a personal interest of the lawyer. This opinion addresses only limitations arising out of the lawyer's responsibilities to another client in connection with the lawyer's representation of that other client on an unrelated matter.

8. For example, where a lawyer may have represented two clients in unrelated matters and both clients were in competition to sell goods to a third party, the representation of one of those clients in negotiating a sale to a third party would not constitute a violation of Rule 1.7(a). See Rule 1.7 cmt. 6.

9. If the testator is bound by a contractual or quasi-contractual obligation to the beneficiary, such as a contract to make a will, then there is a conflict of legal rights and duties, the testator and beneficiary are directly adverse, and the lawyer could not prepare instruments in derogation of her other client's legal rights.

10. For example, in Louisiana, a child under the age of twenty-three or under a permanent disability cannot be disinherited of a specified portion of the parent's estate except for just cause. See LA. REV. STAT. ANN. art. 1493 (West 2004). Louisiana Civil Code article 1621 prescribes "just causes" for disinheritance. Because the statutory language defining "just cause" is subject to interpretation, see e.g., LA. CIV. CODE

free to dispose of his estate as he chooses, or to consume his entire estate during his lifetime or give it all away, leaving nothing to pass under his will. A potential beneficiary, even one who has been informed by the testator that he has been named in a testamentary instrument, has no legal right to that bequest but has, instead, merely an expectancy.[11] Thus, except where the testator has a legal duty to make the bequest that is to be revoked or altered, there is no conflict of legal rights and duties as between the testator and the beneficiary and there is no direct adverseness.[12]

Even though there is no direct adverseness, a concurrent conflict of interest exists when there is a significant risk that the lawyer's representation of the testator (i.e., the lawyer's exercise of independent professional judgment in considering, recommending, and carrying out an appropriate course of action to implement the testator's directions), will be materially limited by the lawyer's responsibilities to her other client.

The preparation of an instrument disinheriting a beneficiary ordinarily is a simple, straightforward, almost ministerial task, without call for the lawyer to consider alternative courses of action, and it is difficult to imagine a circumstance in which a responsibility of the lawyer to her other client (even a client who is a presumptive beneficiary of the testator's bounty) would pose a significant risk of limiting the lawyer's ability to discharge her professional obligations to the testator. The lawyer's representation of a testator does not, of itself, create responsibilities owed by the lawyer to prospective beneficiaries (even one who is the lawyer's client as to an unrelated matter), other than the duty to effect the testator's intent as expressed explicitly or implicitly in the instrument.[13] If, however, because of her relationship with the other client,

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ANN. art. 1621A(2) (West Supp. 2003) ("The child has been guilty, towards a parent, of cruel treatment, crime, or grievous injury."), or LA. CIV. CODE ANN. art. 1621A(8) ("The child, after attaining the age of majority and knowing how to contact the parent, has failed to communicate with the parent without just cause for a period of two years...."), the lawyer would have to advise the testator as to his legal right to disinherit the lawyer's other client. This differs from a widow's dower rights to elect to take against a testamentary instrument, which cannot be avoided for "just cause." See generally, LA. CIV. CODE ANN. arts. 889, 894, and 2434-37.

11. See George Gleason Bogert & George Taylor Bogert, LAW OF TRUSTS & TRUSTEES §103, 242-43 (rev'd 2d ed. 1984) ("The theory of the operation of a will or transaction which has a testamentary effect is that ... until the testator dies leaving the will in effect the donee has a mere expectancy, and ... the testator has power, up to the moment of his death, to revoke the will or amend it by a codicil, or to consume, sell, or give away the property which was the subject matter of the gift described in the will.").

12. See Chase v. Bowen, 771 So.2d 1181, 1185-86 (Fla. App. 2000) (no conflict exists when lawyer revises will to disinherit beneficiary that lawyer represents on unrelated matter).

13. RESTATEMENT (THIRD) OF LAW GOVERNING LAW. § 51 (2000). See also Moore v. Anderson Zeigler Disharoon Gallagher & Gray, 135 Cal. Rptr.2d 888, 895-96 (Cal.

the lawyer finds it repugnant or distasteful to carry out the assignment, or has good faith doubts as to whether there is a significant risk that she will be able to exercise independent professional judgment on behalf of the testator, then the lawyer may decline the engagement.[14]

The issue becomes more complicated if the testator asks for the lawyer's advice as to whether the beneficiary should be disinherited, or if the lawyer initiates such advice, either as a matter of the lawyer's usual practice in dealing with such matters, or because the lawyer believes that such advice is, in the circumstances, in the testator's interest.[15] By advising the testator whether, rather than how, to disinherit the beneficiary, the lawyer has raised the level of the engagement from the purely ministerial to a situation in which the lawyer must exercise judgment and discretion on behalf of the testator. In such circumstances, there is a heightened risk that the lawyer may, perhaps without consciously intending to do so, seek to influence the testator to change his objectives[16] in favor of her other client, thus permitting her representation of the testator to be materially limited by her responsibilities to the beneficiary or by a personal interest arising out of her relationship with the beneficiary.

Problems also can arise in situations where the lawyer has represented both the testator and other family members in connection with family estate plan-

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Ct. App. 2003) (lawyer amending will owes no duty to disinherited heirs to ascertain client's testamentary capacity). See also ABA Comm. on Ethics and Professional Responsibility Formal Op. 02-428, supra note 4, at n.12 (lawyer ordinarily does not owe a current client any duty in connection with estate planning services performed for another client). If the heir were an intended beneficiary of the testator's engagement of the lawyer, then under the "third party beneficiary" test, the heir might be able to maintain a legal malpractice action against the lawyer for negligent performance of the engagement. See generally Neal v. Baker, 551 N.E.2d 704, 705 (Ill. App. 1990), appeal denied, 555 N.E.2d 378 (Ill. 1990) (nonclient must prove that primary purpose and intent of the attorney-client relationship is to benefit or influence third party). See also Osornio v. Weingarten, 21 Cal.Rptr.3d 246, 263-68 (Cal. Ct. App. 2004) (intended beneficiary of will who lost testamentary rights because of failure of lawyer who drew will to fulfill obligations under contract with testator properly may recover as third-party beneficiary);Trask v. Butler, 872 P.2d 1080, 1083-84 (Wash. 1994) (whether lawyer owes duty of care to nonclient depends in part on extent to which transaction was intended to benefit nonclient).

14. See Rule 1.16(a)(1) (lawyer must withdraw if representation will result in violation of rules of professional conduct), and Rule 1.16(b)(4) (lawyer may withdraw if client insists upon taking action that lawyer considers repugnant or with which lawyer has a fundamental disagreement).

15. See Rule 2.1 cmt. 5 (lawyer may initiate unrequested advice to client when doing so appears to be in client's interest).

16. The lawyer ordinarily should abide by the testator's decision concerning the objectives of the representation, as required by Rule 1.2(a). This does not mean that a lawyer may not challenge the testator's decision, but that she must do so solely in the testator's interest, and without considering the interest of her other client (whom we have assumed the lawyer represents only as to unrelated matters).

ning.[17] If proceeding as the testator has directed violates previously agreed-upon family estate planning objectives, the lawyer must consider her responsibilities to other family members who have been her clients for family estate planning.

If, for instance, a family has made its estate plans on the shared assumption (never reduced to an enforceable agreement) that the testator has provided for a disabled family member, thus relieving the others of that burden, then the lawyer may conclude that, in light of her responsibilities to her other clients, she cannot in good conscience implement the testator's intended disinheritance of that disabled family member, especially if the testator refuses to permit the lawyer to reveal the disinheritance.

In summary, ordinarily there is no conflict of interest when a lawyer undertakes an engagement by a testator to disinherit a beneficiary whom the lawyer represents on unrelated matters. However, this may not be the case if the testator is restricted by a contractual or quasi-contractual legal obligation from disinheriting the beneficiary, or if there is a significant risk that the lawyer's responsibilities to the testator will be materially limited by the lawyer's responsibilities to the beneficiary, as may be the case if the lawyer finds herself advising the testator whether to proceed with the disinheritance.

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17. Such family representation is not uncommon, see ABA Comm. on Ethics and Professional Responsibility Formal Op. 02-428, supra note 4, at n.2 and accompanying text, and may desirably facilitate efficient, quality representation by enabling the lawyer and her firm to achieve a deep understanding of a family and its businesses, assets, documents, and personalities.

Chapter 2

PLANNING FOR OREGON'S ELECTIVE SHARE

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Beginning with deaths that occurred on or after January 1, 2011, an entirely new way to determine the elective share rights of surviving spouses took effect in Oregon. Although the Legislative Assembly passed the new elective share act in 2009, it delayed the effective date to give practitioners time to adjust. The Legislature also made some technical corrections to the law in the 2011 session. The new act, including the 2011 corrections, is codified at ORS 114.600 to 114.725, and reproduced at the end of these materials.

I. WHY THE CHANGES?

The new elective share act makes fundamental changes in Oregon's approach to the rights of a surviving spouse to claim a share of the estate of the decedent spouse. Among other things, it cures a fundamental flaw in the prior elective share statutes: the ease with which one spouse could prevent an election by his or her spouse, merely by putting assets in trust, or otherwise having them pass outside of the probate estate. To stop this, the new elective share law bases the election on an augmented estate, which includes nonprobate estate assets, such as a trust set up by the decedent spouse.

The elective share law cures another flaw in the prior law: the ability of a relatively wealthy surviving spouse to elect against the estate of a less wealthy decedent spouse. It does this by including the surviving spouse's assets in the augmented estate. Eliminating elective share claims by relatively wealthy spouses is a significant component of the change in the law.

Under prior law, ORS 114.105 to 114.165, the surviving spouse had a right to elect to take up to 25% of the net probate estate of the decedent spouse, less the value of any assets passing to the surviving spouse. Under the new elective share act, the election can be for as much as 33% of the augmented estate for a marriage that has lasted 15 years or more. The percentage starts at 5% for marriages of less than two years' duration and increases by 2% for each additional year of marriage until, for a marriage lasting 15 years or longer, it reaches the 33% maximum. To the extent the surviving spouse's own estate, including transfers from the decedent spouse, equals or exceeds the prescribed percentage of the augmented estate, no election is allowed.

II. THE AUGMENTED ESTATE

The augmented estate is defined in ORS 114.630(1) as the decedent's probate estate, the decedent's nonprobate estate, and the surviving spouse's estate. The decedent's probate and nonprobate transfers to the surviving spouse are included in the definition of the surviving spouse's estate. ORS 114.675. The augmented estate is calculated net of enforceable claims and encumbrances against the property. ORS 114.630(2). The present value of future interests, including interests in trusts, annuities, disability compensation, and pensions, are included in the augmented estate. ORS 114.630(3). Irrevocable gifts completed before death, community property, and any assets held solely

in a fiduciary capacity are excluded from the augmented estate. ORS 114.635.

The augmented estate includes the surviving spouse's estate, defined to include all of the assets of the surviving spouse, any assets transferred to the spouse from the decedent, whether through probate or nonprobate transfers, and any assets that would be included but for a disclaimer by the surviving spouse. ORS 114.675.

ORS 114.665 defines the decedent's nonprobate estate to include revocable trusts, accounts in the decedent's name with transfer on death (TOD) or pay on death (POD) beneficiary designations, fractional interests in real or personal property owned by the decedent in a survivorship form of tenancy, property the decedent could have acquired before death by exercising a power to revoke, and property over which the decedent had the power to designate a beneficiary (but only to the extent the decedent could have named the spouse or the decedent as beneficiary).

The decedent's nonprobate estate value is reduced by the decedent's debts and liabilities not paid in probate and the costs of administering the nonprobate estate, including the costs of settling nonprobate claims and distributing nonprobate property. ORS 114.660.

The nonprobate estate does not include the present value of a life insurance policy payable on the death of the decedent. However, the policy is included in the decedent's nonprobate transfers to the surviving spouse to the extent that the proceeds are payable to the spouse. ORS 114.690(1)(c).

III. WAIVER

As with the prior elective share statutes, ORS 114.620 allows spouses to relinquish their elective share rights by an agreement or waiver entered into before or after the marriage and signed by at least the surviving spouse. Despite the changes in the rights waived, Section 24 of chapter 574 Oregon Laws 2009, set out in a note below ORS 114.620, provides that waivers executed prior to January 1, 2011, and even before the date of enactment, are as enforceable as those executed after.

IV. CLAIMING THE ELECTIVE SHARE

The elective share may be claimed only if the value of the surviving spouse's estate is less than the specified percentage of the augmented estate value. For long-term marriages (defined as 15 years or more), the election is possible if the surviving spouse's estate is less than 33% of the augmented estate. For the newly married, the surviving spouse can make the election if his or her estate is less than 5% of the augmented estate. The percentage rises by 2% for each additional year of marriage, up to 15 years. ORS 114.605.

The elective share must be claimed during the surviving spouse's life by the surviving spouse or by his or her agent, guardian, or conservator. ORS 114.600 and 114.625. However, once the claim is made, the later death of the surviving spouse will not prevent his or

her personal representative from continuing to pursue the claim. ORS 114.600(1). The surviving spouse has nine months after the decedent spouse's death to file a claim for the elective share. ORS 114.610.

The surviving spouse's nine-month window in which to bring the claim has a potential for mischief. It may interfere with preparation of estate and inheritance tax returns, which are due, unless an extension is requested, within nine months of the decedent spouse's death. Possibly more of a problem is that a disclaimer decision also must be made within nine months of the date of the decedent's death, with no ability to extend that date. IRC § 2518(b)(2). Beneficiaries will likely be unwilling to make disclaimer decisions if the surviving spouse can shift the ground out from under them with a last-minute elective share claim. The nine-month window to make the elective share also applies to small estates. ORS 114.555(2).

Although the nine-month time limit in which to bring a claim is generally at odds with estate and gift tax planning, the new elective share act is coordinated with estate tax rules for valuation purposes. For instance, ORS 114.630(4) generally will allow estate tax values to be used for determining the value of assets in the augmented estate. ORS 114.675(2) sets the value in the surviving spouse's estate of trusts established by the decedent for the benefit of the surviving spouse at 100% of the principal amount if the trust requires that income be paid to the spouse and allows the invasion of principal exclusively for the spouse's benefit. The value is 50% of the principal amount for an identical trust that does not permit the invasion of principal. Therefore, typical QTIP trusts for the surviving spouse can be used in planning without triggering elective share claims.

The 2011 corrections, at ORS 114.675(2)(e), mandated that the value of other trusts in which the surviving spouse has a beneficial interest are to be valued using conventional valuation techniques that apply to the augmented estate in general. See also ORS 114.630(3), bringing into the augmented estate the present value of amounts payable under any trust.

Also in keeping with tax concepts, ORS 114.630(2) allocates to the surviving spouse any exemptions and deductions attributable to the marriage of the surviving spouse and the decedent.

V. CONTRIBUTION TO PAYMENT BY ALL OTHER BENEFICIARIES

If the surviving spouse makes an elective share claim, ORS 114.700 requires that all other recipients of the decedent's probate and nonprobate assets contribute a ratable share toward the payment of the elective share. The obligation to contribute toward the payment of the elective share extends to those who acquire assets from original recipients of the assets "for less than fair consideration." ORS 114.705(1)(b). The 2011 technical correction to the elective share act allows the decedent spouse to direct who must contribute to the elective share in a will, trust agreement, or other governing instrument. ORS 114.700(3).

VI. POTENTIAL PROBLEM AREAS

Although there were numerous changes to the elective share act as it went through the legislative process, and in the 2011 correction, there are still some difficult issues that may create problems, including the following.

✦ The act mandates, at ORS 114.700, that each person receiving assets from the augmented estate contribute ratably to the payment of the elective share amount, unless the decedent spouse allocates the responsibility, as permitted by the 2011 technical corrections. ORS 114.700(3). Attorneys should consider whether the default provision is consistent with the client's wishes. For instance, a decedent spouse who makes gifts to charity and to children might prefer that the charity not be required to contribute to the payment of the elective share.

✦ If the effect of the surviving spouse's election is to reduce a beneficiary's share of an IRA or other retirement plan account, the new elective share act creates a potential tax trap. If the beneficiary takes a distribution from a conventional IRA to pay the claim, the distribution will be taxable for federal and state income tax purposes. There is no provision allowing the named IRA beneficiary an offset for those income taxes. However, in Private Letter Ruling 200438045, involving an elective share claim, the IRS allowed the claimed portion of the IRA, which was distributed directly to the electing spouse, to be treated as a spousal IRA and allowed the spouse to roll the elective share amount into the spouse's own IRA, so that no income tax was due. Note that if the amount to be taken from the IRA to pay an elective share claim is small, it is unlikely the parties will be able to get a private letter ruling blessing that tax result.

✦ The electing surviving spouse's right to recover property extends beyond devisees and distributees of the decedent spouse's property to those who receive the property from those devisees and distributees if they have not paid "fair consideration" for the property. ORS 114.705(1)(b). Since whether "fair consideration" was paid will ultimately be decided by persons who are not involved in the transaction, it may be difficult for an estate or beneficiary to liquidate assets during the pendency of an elective share claim.

✦ If the decedent's property passes by operation of law to a recipient living in another state, to what extent will the Oregon court have jurisdiction to force that recipient to contribute to the payment of the elective share? What if the asset in question is real property located in the other state?

✦ If a beneficiary of the decedent's nonprobate estate cannot be forced to contribute to the payment of the elective share because that beneficiary is beyond the jurisdiction of the Oregon court or is otherwise judgment proof, how does that affect the obligation of other beneficiaries to contribute?

✦ In the few estates where there is a risk of an elective share claim, the surviving spouse's nine-month period to make an elective share decision may have an adverse effect on the prompt administration

of both probate and nonprobate assets, create uncertainty with respect to the issuance of title insurance on conveyances of real property prior to the period running, disrupt beneficiaries' willingness to make disclaimers, and double the time necessary to resolve small estates under ORS 114.555(2).

✦ For purposes of determining the value of the augmented estate, the value of a discretionary trust naming the surviving spouse as sole beneficiary, although qualifying as Oregon special marital property under ORS 118.013, is at best unclear under the elective share act. Note that other trusts with terms that allow them to qualify for the QTIP marital deduction are specifically valued in ORS 114.675(2). The 2011 technical corrections make clear the court is to determine the value of other types of trusts if the parties cannot agree on their own. ORS 114.675(2)(e).

✦ Will surviving spouses who signed waivers of the easily defeated elective share rights under the prior law challenge application of that waiver to the much more significant rights granted under the new law? Courts may well hold that such waivers are inapplicable to the new rights granted by the new elective share act.

VII. PLANNING TO AVOID PROBLEMS

Although the elective share act is now in effect, practitioners still have a chance to amend plans for clients to eliminate many of the harsh consequences that might otherwise occur as a result of the elective share act.

For instance, the uncertain value of a fully discretionary trust for the exclusive benefit of the surviving spouse means that such a trust, even though it qualifies for Oregon's special marital property deduction under ORS 118.013, may be less desirable for planning purposes than a trust eligible for a QTIP election, which is automatically valued at 50% of the value of the corpus under ORS 114.675(2)(c) or at 100% if the trust allows discretionary principal distributions. ORS 114.675(2)(b)

Practitioners can draft provisions to avoid the rigid pro rata contribution requirement for payment of the elective share under ORS 114.700, if it is apparent during the planning that there is a risk that a client's spouse will have the ability to assert an elective share claim.

As an example, if a client wishes to leave a specific asset to his or her children, an amount to charity, and the rest to the spouse, the governing document could have a formula distribution clause to limit the distribution to charity to an amount that would guarantee that the surviving spouse receives at least 33% of the augmented estate. Such a clause will ensure the children will not have to contribute to the elective share payment, allowing them the full benefit of the specific asset. Alternatively, practitioners can write a formula clause to fund a QTIPable trust with an amount sufficient to guarantee the surviving spouse's estate will be large enough to eliminate an elective share claim and leave the rest of the estate to others.

Planners should probably encourage clients to leave IRAs or other retirement plan accounts to the spouse, where that is acceptable, rather than to the children, to make sure the children do not get caught in the potential IRA tax trap. If a client, understanding the problem, still wants to name a child as beneficiary of an IRA, it might be useful to name the spouse as a disclaimer beneficiary of the account, to give the child the ability to disclaim a portion of the IRA. Such a disclaimer will avoid any potential tax liability to the child for a distribution taken to pay the claimed elective share.

Note that estate plans in which the spouse has no intent to treat the surviving spouse unfairly may run afoul of the new elective share law if there is a distortion of values between the time the plan is written and the time the client dies. For instance, a plan that leaves one or more specific assets (such as a family business) to the children and the rest to the surviving spouse might, at the time it is written, leave a large share of the future augmented estate to the surviving spouse. However, if the relative value of the business shifts after the plan is finalized, the surviving spouse may be left with less than the statutory percentage of the augmented estate, and the children might have to contribute to an unexpected elective share claim.

Practitioners will want to look at existing plans to see if any have the potential to trigger elective share rights and determine the best fix for the problem.

A practitioner whose client is a beneficiary of an estate in which an elective share claim has been asserted might wish to file for a protective order under ORS 114.710 to block transfers of property that might leave other beneficiaries judgment proof and unable to contribute toward the payment of the elective share.

VIII. CONCLUSION

The new elective share act changes the thought process clients must go through when developing a plan that splits assets between the testator's spouse and other beneficiaries. With careful planning, practitioners should be able to avoid surprises when the client dies.

APPENDIX—ORS 114.600 THROUGH 114.725, ELECTIVE SHARE FOR DECEDENTS WHO DIE ON OR AFTER JANUARY 1, 2011

(Generally)

114.600 Elective share generally. (1) If a decedent is domiciled in this state on the decedent's date of death, and the decedent is survived by a spouse, the surviving spouse of the decedent may elect to receive the elective share provided by ORS 114.600 to 114.725. An election under ORS 114.600 to 114.725 must be made before the death of the surviving spouse by the filing of a motion or petition in the manner described in ORS 114.610. If a motion or petition is filed within the time specified in ORS 114.610, and the surviving spouse dies before payment of the elective share, the personal representative for the estate of the surviving spouse may take all steps necessary to secure payment of the elective share under ORS 114.600 to 114.725.

(2) Any amounts received under ORS 114.015 are in addition to the elective share provided for in ORS 114.600 to 114.725.

(3) If a decedent dies while domiciled outside this state, any right of a surviving spouse of the decedent to take an elective share in property in this state is governed by the law of the decedent's domicile at death. [2009 c.574 §2]

Note: Section 23, chapter 574, Oregon Laws 2009, provides:

Sec. 23. Sections 2 to 20 of this 2009 Act [114.600 to 114.725] and the amendments to ORS 114.555 by section 21 of this 2009 Act apply only to the surviving spouses of decedents who die on or after the effective date of this 2009 Act [January 1, 2011]. Notwithstanding the repeal of ORS 114.105, 114.115, 114.125, 114.135, 114.145, 114.155 and 114.165 by section 25 of this 2009 Act, the rights of a surviving spouse of a decedent who dies before the effective date of this 2009 Act shall continue to be governed by the law in effect immediately before the effective date of this 2009 Act. [2009 c.574 §23]

114.605 Amount of elective share. (1) Except as otherwise provided in ORS 114.600 to 114.725, the amount of the elective share is a dollar amount determined by multiplying the augmented estate by the percentage provided in this section. All properties included in the augmented estate shall be determined as provided in ORS 114.600 to 114.725. A court of this state has authority to order distribution under ORS 114.600 to 114.725 of all properties included in the augmented estate under ORS 114.600 to 114.725.

(2) The elective share of a surviving spouse is determined by the length of time the spouse and decedent were married to each other, in accordance with the following schedule:

If the decedent and the spouse were married to each other:	The elective-share percentage is:
Less than 2 years	5% of the augmented estate
2 years but less than 3 years	7% of the augmented estate
3 years but less than 4 years	9% of the augmented estate
4 years but less than 5 years	11% of the augmented estate
5 years but less than 6 years	13% of the augmented estate
6 years but less than 7 years	15% of the augmented estate
7 years but less than 8 years	17% of the augmented estate
8 years but less than 9 years	19% of the augmented estate

9 years but less than 10 years	21% of the augmented estate
10 years but less than 11 years	23% of the augmented estate
11 years but less than 12 years	25% of the augmented estate
12 years but less than 13 years	27% of the augmented estate
13 years but less than 14 years	29% of the augmented estate
14 years but less than 15 years	31% of the augmented estate
15 years or more	33% of the augmented estate

[2009 c.574 §3]

114.610 Manner of making election. (1) A surviving spouse may claim the elective share only by:

(a) Filing a petition for the appointment of a personal representative for the estate of the deceased spouse, and a motion for the exercise of the election as described in paragraph (b) of this subsection, within nine months after the spouse dies.

(b) Filing a motion for the exercise of the election in a probate proceeding commenced for the estate of the deceased spouse under ORS 113.035. The motion must be filed not later than nine months after the death of the decedent. A copy of the motion must be served on the personal representative, on all persons who would be entitled to receive information under ORS 113.145 and on all distributees and recipients of portions of the augmented estate known to the surviving spouse who can be located with reasonable efforts. A surviving spouse may withdraw a motion for an election filed under this subsection at any time before the court enters an order granting the motion.

(c) Filing a petition for the exercise of the election under ORS 114.720 (1) within nine months after the death of the decedent.

(2) If a court determines that the elective share is payable, the court shall determine the amount of the elective share and shall order its payment pursuant to the priorities established under ORS 114.700. If it appears that property has not come into the possession of the personal representative, or has been distributed by the personal representative, the court nevertheless shall fix the liability of any person who has any interest in the property or who has possession thereof, whether as trustee or otherwise. [2009 c.574 §4]

114.615 Payment of elective share. In determining whether any payment is required to a surviving spouse in satisfaction of the elective share provided for in ORS 114.605, the court shall consider the values of the decedent's probate estate, the decedent's nonprobate estate, the surviving spouse's estate, the decedent's probate transfers to the surviving spouse and the decedent's nonprobate transfers to the surviving spouse. If the court determines that the aggregate value of the surviving spouse's estate, the decedent's probate transfers to the surviving spouse and the decedent's nonprobate transfers to the surviving spouse do not satisfy the amount of the elective share, any additional amount required to satisfy the elective share shall be paid out of the decedent's probate estate and the decedent's nonprobate estate in the manner provided by ORS 114.700. [2009 c.574 §5]

114.620 Waiver of right to elect and other rights. (1) The right of election under ORS 114.600 to 114.725 may be waived, wholly or partially, before or after marriage by a written contract, agreement or waiver signed by the surviving spouse.

(2) Unless specifically provided otherwise, a written agreement that waives all rights in the property or estate of a present or prospective spouse, using the phrase "all rights" or other equivalent language, or a complete property settlement entered into after or in anticipation of separation or divorce is a waiver of all rights to an elective share under ORS 114.600 to 114.725 by each spouse in the property of the other and a renunciation by each of all benefits that would otherwise pass to each spouse from the other by intestate succession or by virtue of any will executed before the written agreement or property settlement. [2009 c.574 §6]

Note: Section 24, chapter 574, Oregon Laws 2009, provides:

Sec. 24. A written contract, agreement or waiver entered into before the effective date of this 2009 Act [January 1, 2011], whether prenuptial or post-nuptial, that waives in whole or in part the elective share of a surviving spouse is effective as a waiver under section 6 of this 2009 Act [114.620] unless a court determines that the contract, agreement or waiver is not enforceable under the standards of section 6 of this 2009 Act. Section 6 (2) of this 2009 Act applies to contracts, agreements or waivers entered into before, on or after the effective date of this 2009 Act. [2009 c.574 §24]

114.625 Who may exercise right of election. The elective share may be personally claimed by a surviving spouse, or may be claimed on the surviving spouse's behalf by a conservator, guardian or agent under the authority of a power of attorney. [2009 c.574 §7]

(Augmented Estate)

114.630 Augmented estate. (1) Except as otherwise provided in ORS 114.600 to 114.725, the augmented estate consists of all of the following property, whether real or personal, movable or immovable, or tangible or intangible, wherever situated:

(a) The decedent's probate estate as described in ORS 114.650.

(b) The decedent's nonprobate estate as described in ORS 114.660 and 114.665.

(c) The surviving spouse's estate, as described in ORS 114.675.

(2) The value attributable to any property included in the augmented estate under ORS 114.600 to 114.725 must be reduced by the amount of all enforceable claims against the property and all encumbrances on the property. Any exemption or deduction that is allowed for the purpose of determining estate or inheritance taxes on the augmented estate and that is attributable to the marriage of the decedent and the surviving spouse inures to the benefit of the surviving spouse as provided in ORS 116.343 (2).

(3) The value attributable to any property included in the augmented estate includes the present value of any present or future interest and the present value of amounts payable under any trust, life insurance settlement option, annuity contract, public or private pension, disability compensation, death benefit or retirement plan, or any similar arrangement, exclusive of the federal Social Security Act.

(4) The value attributable to property included in the augmented estate is equal to the value that would be used for purposes of federal estate and gift tax laws if the property had passed without consideration to an unrelated person on the date that the value of the property is determined for the purposes of ORS 114.600 to 114.725.

(5) In no event may the value of property be included in the augmented estate more than once. [2009 c.574 §8; 2011 c.305 §4]

Note: Section 7, chapter 305, Oregon Laws 2011, provides:

Sec. 7. The amendments to ORS 114.630, 114.635, 114.660, 114.665, 114.675 and 114.700 by sections 1 to 6 of this 2011 Act apply to the surviving spouses of all decedents who die on or after the effective date of this 2011 Act [June 9, 2011]. [2011 c.305 §7]

114.635 Exclusions from augmented estate. The augmented estate does not include:

(1) Any value attributable to future enhanced earning capacity of either spouse;

(2) Any property that is irrevocably transferred before the death of the decedent spouse;

(3) Any property that is transferred on or after the date of the death of the decedent spouse with the written joinder or written consent of the surviving spouse;

(4) Any property that is community property under ORS 112.705 to 112.775 or under the laws of the jurisdiction where the property is located; or

(5) Any property that is held by either spouse solely in a fiduciary capacity. [2009 c.574 §9; 2011 c.305 §1]

Note: See note under 114.630.

(Decedent's Probate Estate)

114.650 Decedent's probate estate. For purposes of ORS 114.600 to 114.725, a decedent's probate estate is the value of all estate property that is subject to probate and that is available for distribution after payment of claims and expenses of administration. A decedent's probate estate includes all property that could be administered under a small estate affidavit pursuant to ORS 114.505 to 114.560. A decedent's probate estate does not include any property that constitutes a probate transfer to the decedent's surviving spouse under ORS 114.685. [2009 c.574 §10]

(Decedent's Nonprobate Estate)

114.660 Decedent's nonprobate estate. For purposes of ORS 114.600 to 114.725, a decedent's nonprobate estate consists of the property described in ORS 114.665 that is not included in the decedent's probate estate and that does not constitute a transfer to the decedent's surviving spouse. The value of the decedent's nonprobate estate is reduced by all debts and liabilities of the decedent that are not paid in probate, and by all costs of administering the decedent's nonprobate estate that are incurred for the purpose of settling claims against the nonprobate estate and distributing the nonprobate estate property to the persons entitled to that property. [2009 c.574 §11; 2011 c.305 §2]

Note: See note under 114.630.

114.665 Decedent's nonprobate estate; property owned immediately before death. (1) A decedent's nonprobate estate includes the decedent's fractional interest in property held by the decedent in any form of survivorship tenancy immediately before the death of the decedent. The amount included in the decedent's nonprobate estate under the provisions of this subsection is the value of the decedent's fractional interest, to the extent the fractional interest passes by right of survivorship at the decedent's death to a surviving tenant other than the decedent's surviving spouse.

(2) A decedent's nonprobate estate includes the decedent's ownership interest in property or accounts held immediately before death under a payable on death designation or deed, under a transfer on death registration or in co-ownership registration with a right of survivorship. The amount included in the decedent's nonprobate estate under the provisions of this subsection is the value of the decedent's ownership interest, to the extent the decedent's ownership interest passed at the decedent's death to any person other than the decedent's estate or surviving spouse or for the benefit of any person other than the decedent's estate or surviving spouse.

(3) A decedent's nonprobate estate includes any property owned by the decedent immediately before death for which the decedent had the power to designate a beneficiary, but only to the extent that the decedent could have designated the decedent, or the spouse of the decedent, as the beneficiary.

(4) A decedent's nonprobate estate includes any property that immediately before death the decedent could have acquired by the exercise of a revocation, without regard to whether the revocation was required to be made by the decedent alone or in conjunction with other persons.

(5) A decedent's nonprobate estate does not include the present value of any life insurance policy payable on the death of the decedent. [2009 c.574 §12; 2011 c.305 §3]

Note: See note under 114.630.

(Surviving Spouse's Estate)

114.675 Surviving spouse's estate. (1) For purposes of ORS 114.600 to 114.725, a surviving spouse's estate is:

(a) The decedent's probate transfers to the spouse, as described in ORS 114.685.

(b) The decedent's nonprobate transfers to the spouse, as described in ORS 114.690.

(c) All other property of the spouse, as determined on the date of the decedent's death.

(d) Any property that would have been included under paragraph (a), (b) or (c) of this subsection except for the exercise of a disclaimer by the spouse after the death of the decedent.

(2) (a) For the purpose of establishing the value of the surviving spouse's estate under this section, the estate includes 100 percent of the corpus of any trust or portion of a trust from which all income must be distributed to or for the benefit of the surviving spouse during the life of the surviving spouse, and for which the surviving spouse has a general power of appointment that the surviving spouse, acting alone, may exercise, during the surviving spouse's lifetime or at death of the surviving spouse, to or for the benefit of the surviving spouse or the surviving spouse's estate.

(b) For the purpose of establishing the value of the surviving spouse's estate under this section, the estate includes 100 percent of the corpus of a trust or portion of a trust created by the decedent spouse, if all income from the trust or portion of a trust must be distributed to or for the benefit of the surviving spouse during the life of the surviving spouse and the trust principal may be accessed only by the trustee or the spouse and only for the purpose of providing for the health, education, support or maintenance of the spouse.

(c) For the purpose of establishing the value of the surviving spouse's estate under this section, the estate includes 50 percent of the corpus of a trust or portion of a trust created by the decedent spouse if all income from the trust or portion of a trust must be distributed to or for the benefit of the surviving spouse during the life of the surviving spouse and neither the trustee nor the spouse has the power to distribute trust principal to or for the benefit of the surviving spouse or any other person during the spouse's lifetime.

(d) For the purposes of this section, all amounts distributed to a surviving spouse from a unitrust that meets the requirements of ORS 129.225 (4) shall be considered income.

(e) The value of the surviving spouse's beneficial interest in a trust other than a trust described in paragraphs (a) to (d) of this subsection shall be determined under the provisions of ORS 114.630 (3) and (4). [2009 c.574 §13; 2011 c.305 §5]

Note: See note under 114.630.

(Decedent's Probate Transfers to Spouse)

114.685 Decedent's probate transfers to surviving spouse. The decedent's probate transfers to the decedent's surviving spouse include all estate property that is subject to probate, that passes to the surviving spouse by testate or intestate succession, and that is available for distribution to the surviving spouse after payment of claims and expenses of administration. [2009 c.574 §14]

(Decedent's Nonprobate Transfers to Spouse)

114.690 Decedent's nonprobate transfers to surviving spouse. (1) Except as provided in subsection (2) of this section, the decedent's nonprobate transfers to the decedent's surviving spouse include all property that passed outside probate at the decedent's death from the decedent to the surviving spouse by reason of the decedent's death, including:

(a) The decedent's fractional interest in property held in any form of survivorship tenancy, as described in ORS 114.665 (1), to the extent that the decedent's fractional interest passed to the surviving spouse as surviving tenant;

(b) The decedent's ownership interest in property or accounts held in co-ownership registration with the right of survivorship, to the extent that the decedent's ownership interest passed to the surviving spouse as surviving co-owner;

(c) Insurance proceeds payable to the surviving spouse by reason of the death of the decedent; and

(d) All other property that would have been included in the decedent's nonprobate estate under ORS 114.660 and 114.665 had it passed to or for the benefit of a person other than the decedent's spouse.

(2) The decedent's nonprobate transfers to the decedent's surviving spouse do not include any property passing to the surviving spouse under the federal Social Security Act. [2009 c.574 §15]

(Payment of Elective Share)

114.700 Priority of sources from which elective share payable. (1) The surviving spouse's estate, as described in ORS 114.675, shall be applied first to satisfy the dollar amount of the elective share and to reduce or eliminate any contributions due from the decedent's probate estate and recipients of the decedent's nonprobate transfers to others.

(2) If after application of the surviving spouse's estate under subsection (1) of this section the elective share amount is not fully satisfied, the following amounts shall be applied to the extent necessary to satisfy the balance of the elective share amount:

(a) Amounts included in the decedent's probate estate.

(b) Amounts included in the decedent's nonprobate estate under ORS 114.600 to 114.725.

(3) Unless otherwise provided by a will, trust or other instrument executed by the decedent spouse:

(a) Amounts applied against the unsatisfied balance of an elective share amount under subsection (2) of this section shall be collected from both the probate and nonprobate estates of the decedent in a manner that ensures that the probate and nonprobate estates bear proportionate liability for the amounts necessary to pay the elective share amount.

(b) Amounts applied against the unsatisfied balance of an elective share amount under subsection (2) of this section out of the probate estate of the decedent must be apportioned among all recipients of the decedent's probate estate in a manner that ensures that each recipient bears

liability for a portion of the payment that is proportionate to the recipient's interest in the decedent's probate estate.

(c) Amounts applied against the unsatisfied balance of an elective share amount under subsection (2) of this section out of the nonprobate estate of the decedent must be apportioned among all recipients of the decedent's nonprobate estate in a manner that ensures that each recipient bears liability for a portion of the payment that is proportionate to the recipient's interest in the decedent's nonprobate estate.

(4) All apportionments under this section between the probate and nonprobate estates of the decedent and among the recipients of those estates shall be based on the assets of each estate that are subject to distribution by the court under the provisions of ORS 114.600 to 114.725.

(5) In any proceeding described in ORS 114.610, the court may allocate the cost of storing and maintaining property included in the augmented estate pending distribution of the property. [2009 c.574 §16; 2011 c.305 §6]

Note: See note under 114.630.

114.705 Liability of recipients of decedent's nonprobate estate. (1) The following recipients of the decedent's nonprobate estate are the only persons who may be required to make a proportional contribution toward the satisfaction of the surviving spouse's elective share under the provisions of ORS 114.600 to 114.725:

(a) An original recipient of all or part of the decedent's nonprobate estate.

(b) A person who has received all or part of the decedent's nonprobate estate for less than fair consideration from an original recipient of the property, to the extent the person has the property or proceeds of the property.

(2) A recipient of all or part of the decedent's nonprobate estate who is required to make a proportional contribution toward the satisfaction of the surviving spouse's elective share may elect to make the contribution by returning property determined to be adequate to satisfy the recipient's obligation or by paying money equal to the value of that property. [2009 c.574 §17]

114.710 Protective order. (1) If a surviving spouse has filed a motion or petition described in ORS 114.610, the surviving spouse or any person who has received any part of the decedent's probate or nonprobate estate may request, at any time after the filing, that the court issue a protective order. The protective order shall prohibit or impose conditions on the transfer of property included in the augmented estate. The protective order may be served on any person holding property included in the augmented estate.

(2) Upon the filing of a motion or petition under ORS 114.610, any person who has received any part of the decedent's probate or nonprobate estate and who is required to make a contribution toward the satisfaction of the elective share may file a motion or petition with the court requesting a determination of the amount of the person's proportionate contribution toward the satisfaction of the elective share. Upon that determination being made, the person may deposit with the court the amount so determined in the form of money or a bond or other security. The deposit discharges the person from all claims relating to the satisfaction of the elective share. In lieu of deposit with the court under this subsection the court may require that the money or security be deposited with a person designated by the court.

(3) If a surviving spouse has filed a motion or petition described in ORS 114.610, and a notice of pendency of action under ORS 93.740 is recorded, a temporary restraining order is issued under ORCP 79, or provisional process is issued under ORCP 83, an owner of the property that is subject to the notice, order or process may seek relief from the notice, order or process by providing

a bond or other security to the court in such amount as the court may determine adequate to satisfy the person's proportionate contribution toward the satisfaction of the elective share. [2009 c.574 §18]

(Procedure)

114.720 Proceedings to claim elective share. (1) A surviving spouse may claim the elective share by filing a petition for the exercise of the election in a circuit court within the time allowed by ORS 114.610 (1)(c). Venue for the proceeding is as provided in ORS 113.015. A copy of the petition must be served on all persons who would be entitled to receive information under ORS 113.145 and on all distributees and recipients of portions of the augmented estate known to the surviving spouse who can be located with reasonable efforts. The fee for filing a petition under this subsection shall be the amount prescribed in ORS 21.170, based on the value of the nonprobate estate. The Oregon Rules of Civil Procedure apply to proceedings under this section. Any party to a proceeding under this section may request that the pleadings and records in the proceeding be sealed.

(2) A surviving spouse may withdraw a petition filed under this section at any time before entry of a judgment on the petition.

(3) If a probate proceeding is commenced for the estate of the deceased spouse under ORS 113.035 either before or after a petition is filed under this section, the court shall consolidate the proceedings under this section with the probate proceedings. [2009 c.574 §19; 2011 c.595 §125]

114.725 Effect of separation. If the decedent and the surviving spouse were living apart at the time of the decedent's death, whether or not there was a judgment of legal separation, the court may deny any right to an elective share or may reduce the elective share to such amount as the court determines reasonable and proper. In deciding if all or part of the elective share should be denied, the court shall consider whether the marriage was a first or subsequent marriage for either or both of the spouses, the contribution of the surviving spouse to the property of the decedent in the form of services or transfers of property, the length and cause of the separation and any other relevant circumstances. [2009 c.574 §20]

Chapter 3

ASSET PROTECTION PLANNING BASICS: ESTATE PLANNING AND BUSINESS TRANSACTIONS

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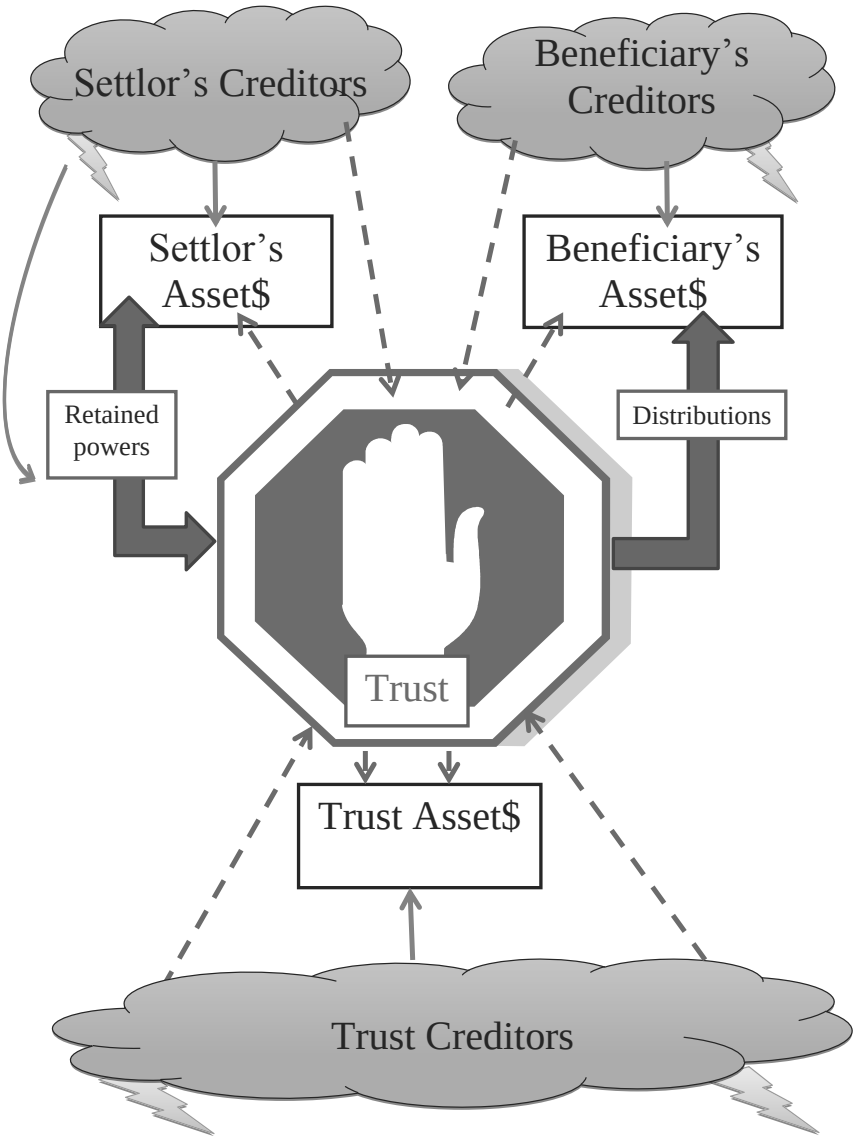
OVERVIEW

These materials are intended to cover basic practical asset protection planning techniques in Oregon. You are unlikely to find anything really new in these materials, but I never cease to be amazed how complex the basics can be and how often even experienced practitioners can miss points, or may misunderstand points, of asset protection planning. I do not cover offshore trusts or other more esoteric techniques, just what we deal with every day, with a focus on gift transfers (in trust or otherwise), transfers at death, and transfers to limited liability entities.

The asset protection planning world may be described as having two hemispheres: self-settled and non-self-settled planning. Self-settled planning is very difficult and risky. Non-self-settled planning is reliable and well understood. The Uniform Fraudulent Transfer Act can make a mess of both.



I. SPENDTHRIFT TRUSTS

A. Oregon's Uniform Trust Code (OUTC), ORS Chapter 130

Spendthrift trusts are widely familiar and often used. They are the classic asset protection device, and, unless self-settled, perhaps still the best asset protection device available. Creditors may generally reach a trust beneficiary's maximum interest in a trust that is not a spendthrift trust, so properly creating and administering a spendthrift trust is critical to successful asset protection planning.

The OUTC specifically addresses spendthrift trusts, at ORS 130.300–.325.

B. Spendthrift Trusts

1. Importance of a Valid Spendthrift Clause. A "spendthrift trust" must include a valid "spendthrift clause." ORS 130.305. To be valid, a spendthrift clause must prohibit the voluntary or involuntary transfer of a beneficiary's interest in the trust. The OUTC and prior cases are fairly liberal as to what words are required of a spendthrift clause, although the OUTC makes clear that the trust must restrict both voluntary and involuntary alienation of the beneficial interest. Since a "valid" spendthrift clause is necessary for spendthrift trust protections, many trust agreements include a lengthier spendthrift clause like the following:

> With respect to any trust created or administered hereunder, the interest of beneficiaries in principal or income shall not be subject to claims of their creditors or others, nor to legal process and may not be voluntarily or involuntarily assigned, anticipated, alienated, or encumbered. No beneficiary shall have any power to sell, assign, transfer, encumber, or in any other manner anticipate or dispose of his or her interest in the trust or the income produced thereby prior to the actual distribution thereof by the Trustee to the beneficiary or to another for the benefit of the beneficiary in the manner authorized by this instrument. Further, the interest of any beneficiary in principal or income is intended solely for the benefit of such beneficiary, not for the benefit of any beneficiary's spouse or family, and shall not be considered a marital asset or be subject to claims against a beneficiary for spousal or child support. These limitations shall not restrict the exercise of any power of appointment or the right to disclaim.

And for good measure, at least prior to passage of the "*Olesberg* fix" (ORS 107.105(1)(f)(D)), one might also include something like the following:

> The Settlor intends to benefit only the persons the Settlor has named or described as beneficiaries in this instrument. The Settlor does not intend to benefit any other person, including any spouse or domestic partner of any person

who is a beneficiary under this instrument. If the property of any beneficiary is subject to division with his or her spouse or domestic partner because of legal separation or dissolution of marriage domestic partnership, it is the Settlor's strong desire and intention that any interest that the beneficiary may have in or derive from the Settlor's assets, probate estate, or trust estate not be considered a marital or domestic partnership asset.

2. Effect of Spendthrift Clause Depends on Identity of Debtor: Against Whom Is the Claim Brought, Settlor or Beneficiary? If the claim is against the settlor, has the settlor reserved rights to reach principal or income of the trust? In general, the settlor's creditors can access trust assets to the maximum extent the settlor can access trust assets.

If the claim is against the beneficiary, does the beneficiary have a right to mandatory distributions? Again, in general, the creditor can reach trust assets to the extent the beneficiary can reach trust assets.

3. Settlor's Creditors

a. Revocable Trusts, Trusts with Retained Settlor Interests. A "self-settled" spendthrift trust is generally what we call a spendthrift trust created by a settlor who retains a beneficial interest. Examples include revocable trusts, retained life estate trusts (where settlor retains income interest), or retained remainder interests.

Revocable trusts provide no protection against claims by creditors of the trust's settlor, even if the revocable trust agreement includes a valid spendthrift clause. ORS 130.315. In general, a settlor's creditors can reach as much of the trust estate as the settlor can reach (but only so much), and a settlor cannot create a spendthrift trust effective against the settlor's own creditors to the extent the trust is for the settlor's own benefit. *In re Kinkaid*, 917 F.2d 1162 (CA9 (Or) 1990); *McGoldrick and McGoldrick*, 85 Or App 412 (Or 1987) (retained life estate); see also "The Oregon Uniform Trust Code and Comments," *Willamette Law Review*, Vol. 42, No. 8, Spring 2006 ("Code and Comments") at 285. The creditor can reach the maximum amount distributable to the settlor and can compel distribution of that amount and garnish distributions.

It is possible that certain unlimited powers to amend or modify a trust agreement may be treated as powers to revoke for spendthrift trust purposes. *In re Roman Catholic Archbishop of Portland in Oregon*, 345 BR 686 (Bkrtcy D Or 2009).

b. Irrevocable Trusts, No Settlor Retained Interest. Because a settlor's creditors can only reach trust assets available to the settlor, assets of an irrevocable trust, with no interest retained by the settlor, are not subject to claims by the settlor's creditors (subject to UFTA).

c. Settlor as Trustee. Under the OUTC, the settlor's status as trustee shouldn't affect spendthrift protection—rather, it is the settlor's status as beneficiary or holder of a power of revocation that can expose

trust assets to the settlor's creditors. If a settlor is trustee of an irrevocable trust in which the settlor has no beneficial interest, the trust should not be exposed to the settlor's creditors, even if the trust assets may be part of the settlor's taxable estate under IRC section 2036 or other string provisions. The same rule applies to custodial accounts. ORS 126.846, 126.859.

However, since the trust will likely be for the benefit of the settlor/trustee's close family members, the trustee/settlor will have many opportunities for mistakes in administration that may support "alter ego" claims (see *Schwartzkopf,* below), even if the transfer to the trust survives UFTA scrutiny. A creditor would certainly try to use the settlor's control over the trust as evidence of fraudulent transfer or retained beneficial interest.

d. CRTs. A CRT functions as a self-settled spendthrift trust, although a creditor may garnish the settlor-beneficiary's retained income interest. See for example *In re Mack,* 269 BR 392 (Bkrtcy D Minn 2001) (pre-UTC but still instructive, particularly as to the federal law overlay).

Note that in *Mack* the court also ruled that the bankruptcy trustee acquired all of the settlor's powers under the trust agreement, including the power to substitute trustees, to control investments, and potentially to change remainder beneficiaries. If the CRUT were a NIMCRUT, the bankruptcy trustee might be able to use these powers to maximize income, including "makeup" income.

4. Beneficiary's Creditors

a. Basic Spendthrift Trust Protection Rule. The assets of a valid spendthrift trust are protected against claims by creditors of a trust beneficiary, unless and until received by the beneficiary. ORS 130.305(3). *Kirkpatrick v. US National Bank,* 264 Or 1 (Or 1972). The OUTC prohibits a beneficiary's creditors from directly attaching the beneficiary's interest in the trust or trust distributions and instead requires a beneficiary's creditors to collect directly from the beneficiary after trust distributions are received. The phrase "unless and until received by the beneficiary" is a critical point, since it effectively prohibits garnishment of trust distributions and therefore may allow trustees more opportunities to protect trust assets, either by withholding discretionary distributions or by making distributions for a beneficiary's benefit, rather than to the beneficiary. See Code and Comments at 285. (Note: a trustee tempted to make nondiscretionary distributions intended to benefit a beneficiary but avoid the beneficiary's creditors should carefully consider the possibility of personal liability).

An illustrative Oregon case is *In re Kragness,* 58 BR 939 (Bkrtcy D Or 1986). A debtor in bankruptcy was the beneficiary of two spendthrift trusts established in Hawaii under Hawaiian law. At the time of bankruptcy, one trust was approximately six months away from terminating and passing its assets to its beneficiaries (including the Oregon debtor) outright and free of trust, but the debtor had to survive

until termination in order to receive her share of the trust assets (debtor's survival was a contingency). The other trust was likely to continue for decades further. The debtor-beneficiary was entitled to mandatory income distributions from both trusts, but only discretionary principal distributions. The rule:

- ✦ The bankruptcy trustee could reach trust income that had been distributed to the debtor after the bankruptcy filing and could compel future mandatory income distributions if the spendthrift trustee refused to make them in the future, but the bankruptcy trustee could not garnish trust distributions (could only wait until distributions were actually made to the beneficiary);
- ✦ The bankruptcy trustee could not reach any other portion of the debtor's beneficial interest or any trust assets, unless and until trust assets were distributed to the debtor;
- ✦ After the debtor's debts were discharged in the chapter 7 bankruptcy, future income distributions from the trust were not subject to the beneficiary's creditors' claims, because those claims had been discharged (note that the result would likely be different under the current Bankruptcy Code, and today the debtor might be forced into a "workout" chapter 13 bankruptcy in light of the debtor's income from the trust).

The case provides a great summary of basic spendthrift trust rules as applied in bankruptcy. The case is particularly helpful because it doesn't involve any of the salacious fraudulent transfers and convoluted self-help scams that in so many asset protection cases seem to affect the court's interpretation of the law. The facts in this case are mundane, allowing the court to make clean and clear rulings on the law. The spendthrift trust rulings are reaffirming, but the more interesting portions of the case involve the creation of a limited liability entity shortly prior to trust termination/distribution, and the 180-day inheritance/gift rule, both discussed below.

b. Exception for Child and Spousal Support Judgments. A long-standing exception to spendthrift trust protection is liability for spousal or child support judgments. ORS 130.310; *Shelley v. Shelley*, 223 Or 328 (Or 1960). However, under the OUTC, even a support creditor cannot force the trustee to make distributions in excess of those required by the trust agreement (meaning, a support creditor cannot compel discretionary distributions and cannot accelerate an income or remainder interest but can garnish mandatory distributions).

c. Forced Payment of Overdue Distributions. A creditor of a beneficiary can compel the trustee to distribute "overdue distributions." ORS 130.320. Overdue distributions are amounts that a trustee is required by the trust agreement to distribute to a particular beneficiary but that have not yet been distributed by the trustee. The rule prevents a sympathetic trustee from holding back distributions due a debtor beneficiary. The overdue distribution rule works for spendthrift trusts, but it can only be used to compel distributions that are required by the trust

agreement (not to compel discretionary distributions and not to garnish beneficial interests).

d. Beneficiary as Trustee. Many QTIP/bypass trusts name the surviving spouse as both beneficiary and trustee. In some dynasty trusts, children or other descendants serve as both trustees and sprinkle beneficiaries. Under the Restatement of Trusts, and possibly under Oregon law prior to the OUTC, a trustee/beneficiary could in some cases be compelled to make discretionary distributions, thereby severely impairing the asset protection benefits of a "traditional" bypass trust. The OUTC has changed/clarified this issue.

Section 504(e) of the UTC has been adopted in various versions in various states. The version many estate planners would like to see is as follows:

> If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee.

The OUTC did not adopt this language (or any other portion of UTC 504), but the OUTC does include what appears to be functionally identical language in ORS 130.315(4). The statute is certainly not as direct and clear on this point as it could be, but the comments to the OUTC are clear:

> Subsection (4) addresses the issue of whether a creditor of a beneficiary may reach the interest of a beneficiary who is also a trustee. . . . [S]ubsection 4 provides that the beneficiary-trustee is protected from creditor claims to the extent the trustee's discretion is limited by an ascertainable standard.

Code and Commentary at 292, commenting on ORS 130.315(4).

> [A] power of withdrawal does not include a power exercisable by a trustee which is limited by an ascertainable standard, thereby precluding a claim that the right of a nonsettlor beneficiary-trustee to make such distributions for the trustee's own benefit results in an enforceable claim of the trustee's creditors to reach the trustee's interest in the trust.

Code and Commentary at 212, commenting on ORS 130.010(12), and referring to ORS 130.315(4).

The OUTC defines "ascertainable standard" to correspond with the term as used in the Internal Revenue Code. "'Ascertainable standard' means an ascertainable standard relating to an individual's health, education, support or maintenance within the meaning of section 2041(b)(1)(A) or 2514(c)(1) of the Internal Revenue Code, as in effect on January 1, 2006." ORS 130.010(1).

So if a bypass trust includes a spendthrift trust provision and limits the trustee's discretionary distribution power to "health, education, support or maintenance," the trust estate should be protected against claims of the beneficiary's creditors, even if the beneficiary is also the trustee.

Oregon's version of this section of the UTC is unique and doesn't appear to have been interpreted by courts or commentators, other than in the Code and Comments. Since the statute itself isn't entirely clear, though the comments are, practitioners may be reluctant to rely entirely on ORS 130.315(4). To add additional protections against creditor claims against a beneficiary/trustee, consider using a cotrustee or trust protector in relation to distributions, and consider discretionary sprinkle powers to other beneficiaries for non-QTIP trusts/shares.

e. Powers of Appointment. A beneficiary's power to appoint trust income or principal to the beneficiary would be treated as a "withdrawal power" under ORS 130.315 and therefore would expose the assets of the trust to the beneficiary's creditors, to the maximum extent of the withdrawal power.

A limited power of appointment should not make the subject trust assets subject to the power available to the power holder's creditors, nor should the holder's creditors be able to exercise the power. See for example *In re Shurley,* 115 F3d 333 (5th Cir 1997).

However, a power of appointment combined with a lifetime income interest may under some circumstances be treated as outright ownership by the holder of the power—for example, a broad, nongeneral testamentary power of appointment held by a lifetime income beneficiary who may also receive discretionary distributions of principal may push the envelope, especially where the beneficiary is also the sole trustee. See *Johnson v. Commercial Bank,* 284 Or 675 (Or 1978). Consider tight limited power restrictions, prohibit support payments, etc.

f. Crummey Powers, Hanging Powers. Under ORS 130.315, a beneficiary's power to withdraw assets exposes those assets to the beneficiary's creditors (in essence, the creditors can force the withdrawal, just as creditors of a settlor of a revocable trust can force a distribution or revocation). For typical short-term Crummey powers, ORS 130.315 means that during the 30- or 60-day withdrawal period, the portion of the trust subject to withdrawal is exposed to the beneficiary's creditors. "Hanging" powers or "5 and 5" powers may create longer-term exposure.

But consider that the holder of the Crummey power may be treated as a settlor of the trust with respect to the extent of the withdrawal power (since by failing to exercise the power, the beneficiary has essentially contributed to the trust). Fortunately, the OUTC addresses this question in ORS 130.315(2) and (3), providing that powers of withdrawal will only cause the power holder to be treated as a settlor so long as the powers have not lapsed, and upon lapse the power holder will only be treated as a settlor to the extent that the share of the trust subject to the

lapsed power is greater than the annual exclusion amount or 5 and 5 amount. See Code and Comments at 292.

g. Trustee Investment in Limited Liability Entity. In *Kragness* that the trustee, just before the terminating trust terminated, transferred most of the trust's assets to a limited partnership. A trustee may effectively extend some of a spendthrift trust's beneficiary creditor protection by transferring trust assets to a limited liability entity before a beneficiary has a right to distribution, and subsequently distributing minority or otherwise restricted interests in the entity to the beneficiary, in lieu of the underlying assets. Similarly, an executor (or trustee of administrative trust) could invest estate assets in limited liability entities prior to distribution and distribute restricted interests in the entities to beneficiaries in lieu of underlying estate assets.

Of course, the trustee or executor may face disgruntled beneficiaries, even concerns about breach of fiduciary duty. If the beneficiaries are required to sign a waiver of claims in relation to entity formation, a creditor might use the waiver as evidence of the beneficiary's control over the asset at the time of transfer to the entity, thereby making the beneficiary the effective transferor of the underlying assets for purposes of UFTA.

h. One Hundred Eighty–Day Rule. To generalize: if a debtor in bankruptcy receives (or becomes entitled to) an inheritance or gift within 180 days after filing, the inheritance or gift will be included in the bankruptcy estate, but if the inheritance or gift is not distributable until after that 180-day period, it will not be part of the bankruptcy estate. Bankruptcy Code § 541(a). In *Kragness*, the beneficiary's share of the spendthrift trust became distributable to the beneficiary/debtor 183 days after the beneficiary filed for bankruptcy protection, and therefore it was not part of the bankruptcy estate.

5. Trustee's Creditors

a. A trustee's creditor cannot reach trust assets. ORS 130.325. However, in some unusual circumstances, a spendthrift protection might be "pierced" (like a limited liability entity) as a result of actions by trustee and/or beneficiaries that make the trust an "alter ego" of the trustee or beneficiary and therefore subject to claims of the creditors of the trustee or beneficiary. For example, in *In re Schwartzkopf* (9th Cir No 08-56974, Nov. 23, 2010), parents created spendthrift trusts for their child, and although they did not appoint themselves as trustees, they appointed a close friend who acted at their direction. The case was decided on fraudulent transfer grounds (transfer to the trust made when debtors insolvent and without consideration), but the more interesting part of the opinion regards the ability of creditors to "pierce" a spendthrift trust where the settlors retain and exercise control over the trust such that it appears to be an "alter ego" of the settlors (the settlors via their controlled trustee paid themselves exorbitant fees, comingled funds, and generally disregarded the trust's separate existence): "In the context of trusts . . . equitable interest is traditionally sufficient to confer ownership rights.

. . . [E]quitable ownership in a trust is sufficient to meet the ownership requirement for purposes of alter ego liability." *Schwartzkopf.*

b. The rule: a spendthrift trust can be pierced under alter ego theories typically applied to limited liability entities, a particularly likely result where trust beneficiaries are spouses or children of the settlor/trustee, and the settlor/trustee has played loose with trust formalities.

6. QTIP/Bypass Trusts. Who is the settlor? Who do we want to be the settlor?

a. The spouse who created and funded the trust—the first spouse to die in a testamentary bypass trust—is the settlor of the trust under OUTC. ORS 130.240, 130.010(16). Therefore, creditors of the surviving spouse can only reach the surviving spouse's beneficial interest when received by the surviving spouse (spouse's beneficial interest may include a mandatory income interest for a QTIP portion of the trust).

b. What about inter vivos QTIPs/bypass trusts? The contributing settlor will remain the settlor. During life of both spouses, the QTIP will be a prime target of UFTA claims. It is possible that a QTIP could provide asset protection value while both spouses are alive, to the extent the funding of the trust survives UFTA attacks. But on death of the first spouse, if the surviving spouse becomes a beneficiary, the surviving spouse would then be a beneficiary of a self-settled spendthrift trust.

This question has been raised, and answered, in some jurisdictions other than Oregon, as a domestic asset protection trust (where the settlor's status as beneficiary does not necessarily expose trust assets to the settlor's creditors).

C. Domestic Asset Protection Trusts, UFTA

This presentation does not involve domestic asset protection trusts. However, I would like to draw attention to the 2005 bankruptcy reform act change that directly addressed self-settled domestic asset protection trusts.

Consider the *Mortensen* case (*Battley v. Mortensen,* 2011 WL 5025288 (Bkrptcy DC Alaska, 2011)), which focuses on Bankruptcy Code § 548(e). Section 548(e) provides a 10-year statute of limitations for fraudulent transfers to self-settled asset protection trusts (extending UFTA's four-year statute). But the fraudulent transfer still must have been made with actual intent to defraud present or future creditors; the creditors just have a longer time to bring a claim. *Mortensen* is one of the first cases directly addressing the treatment of self-settled domestic asset protection trusts in bankruptcy, and it illustrates that bankruptcy courts are capable of treating transfers to such trusts as fraudulent, thereby stripping the trust of asset protection benefit.

So: do self-settled spendthrift trusts work? Maybe in certain jurisdictions and with good facts. But even then, onshore asset protection planning may just be a simpler form of offshore trust planning, meaning it's a game of barriers and chicken, with a judge's contempt powers as the final word. Self-settled spendthrift trusts might work in those states

that approve them, but we may never know, since debtors who pursue such strategies are so likely to fund the trust with a fraudulent transfer or otherwise undermine the trust's asset protection value.

II. FRAUDULENT TRANSFERS: UNIFORM FRAUDULENT TRANSFER ACT (UFTA), ORS CHAPTER 95

A. "Actual Fraud:" ORS 95.230(1)(a)

Under ORS 95.230(1)(a), a transfer is "fraudulent" as to present or future creditors if the debtor made the transfer with "actual intent" to "hinder, delay, or defraud any creditor of the debtor." The classic example would be a transfer shortly after being sued or after incurring some liability.

To determine the debtor's actual intent, courts look to facts relating to the transfer, circumstantial evidence as it were. These facts are referred to as "badges of fraud" (ORS 95.230(2)(a)–(k)). The "badges" include retention of control or benefits of transferred assets; concealment of the transfer; insolvency as a result of the transfer; and proximity of the transfer to a creditor's claim. See for example *Doughty v. Birkholtz*, 156 Or App 89 (Or App 1998); *Smith v. Popham*, 266 Or 625 (Or 1973); *Skerry v. Lamb*, 248 Or 147 (Or 1967).

B. "Constructive Fraud:" ORS 95.230(1)(b)

Under ORS 95.230(1)(b), a transfer is "fraudulent" as to present or future creditors if the transfer was made for less than equivalent value while or shortly before the debtor engaged in a transaction or otherwise incurred debts beyond the debtor's ability to pay.

1. What Is a Future Creditor? Can just any creditor whose claim arises after a transfer rely on ORS 95.230(1)(a)? No: the debtor must have actually intended the defraud the creditor for a creditor to bring a claim under ORS 95.230(1)(a).

How about claims under ORS 95.230(1)(b)? If "constructive fraud" does not require a showing of actual intent with respect to a particular creditor, can just any future creditor rely on ORS 95.230(1)(b)? The plain language of UFTA, and of some cases, suggests yes, any future creditor can bring a claim based on constructive fraud, regardless of a connection between the transfer and the creditor's claim. However, on closer reading of cases and commentary, it appears that to be a "future creditor" that can rely on ORS 95.230(1)(b), the creditor's claim must have some relation to the transfer, and, in particular, the future creditor's claim must have been foreseeable, proximate, or otherwise contemplated at the time of the transfer—but Oregon law may be unclear on this point.

Can a future claimant you haven't even met some day take back the birthday presents you gave last year?

2. Case Law. Oregon case law provides little guidance on this point. However, what little guidance is out there is disturbing. It seems unlikely that a creditor would be able to set aside a prior transfer made by the debtor before the creditor had any relationship with the

debtor. Yet *Battley v. Mortensen,* 2011 WL 5025288 (Bkrptcy DC Alaska, 2011), *US v. Townley,* 2006 WL 1345248 (9th Cir May 17, 2006), and the plain language of Oregon's UFTA suggest that constructive fraud (under ORS 95.230(1)(b)) may protect very remote future creditors, perhaps even creditors who had no relationship with the debtor at the time of transfer. A debtor/transferor's final protection may be UFTA's statutes of limitation.

Note, however, that in both *Mortensen* and *Townley,* the asset protection transfers probably could have been be construed as fraudulent transfers under the actual intent test, and in fact a close reading suggests that both cases were in fact decided on fraudulent transfer theories under the actual intent test. Therefore, despite the disturbing language of *Mortensen* and *Townley,* we may still have no real case on point in Oregon and can still only speculate as to how far the definition of "future creditor" extends—the facts in these cases are so bad that it is hard to tell exactly how far the legal analysis goes.

In *Townley,* the defrauded creditor was the IRS, and the debtors/transferors were behind on their taxes at the time of the fraudulent transfers and thereafter became tax "protestors" (apparently refusing to pay taxes on constitutional or moral grounds—always a good way to tempt a federal judge to use his or her powers to the fullest).

In *Mortensen,* the defrauded creditors (credit card companies among them) were owed money at the time of the transfer, but the debtor/transferor was not then in default. However, shortly after the transfer the debtor embarked on a "frenzy" of credit card activity and more than tripled his debt load before declaring bankruptcy. The debtor also appears to have been insolvent at the time of the transfer, never had income sufficient to support his debt load (not even at the time of the transfer), and may have comingled trust and personal assets.

3. Apparent General Rule. The apparent general rule outside the Ninth Circuit, and the one argued by asset protection promoters, is that unforeseen or otherwise remote future creditors are not protected by the statute. For purposes of UFTA in some states, a future creditor is one whose claim is foreseeable, proximate, or otherwise contemplated at the time of the transfer. Other creditors, who have no claim at the time of the transfer and whose claims were not specifically foreseeable at the time of the transfer, would not be able to set aside the transfer. See for example *Leopold v. Tuttle,* 378 Pa. Superior Ct. 466 (1988), *Hurlbert v. Shackleton,* 560 So.2nd 1276 (Fla Ct. App. 1990).

For excellent discussion and analysis of the treatment of future creditors under UFTA, see:

- ✦ "Ninth Circuit Treads on an Established Right," Rothschild and Rubin, *Trusts & Estates,* Nov. 2006;
- ✦ "Asset Protection May Risk Fraudulent Transfer Violations," Stein, *Estate Planning,* Vol. 37 No. 8, August 2010; and
- ✦ "Court Finds Fraudulent Transfer to Alaska Asset Protection Trust," Shaftel, *Estate Planning,* Vol. 39 No. 4, April 2012.

4. Statutes of Limitation. Statutes of limitation under UFTA may be the only safe harbor for fraudulent transfers under ORS 95.230(1)(b).

a. Four Years. Under ORS 95.280(1) and (2), claims are extinguished four years after the transfer, if the transfer was made with actual or constructive intent to defraud a present or future creditor.

b. One Year. Under ORS 95.280(3), claims are extinguished one year after the transfer if the transfer was to an "insider." Because of substantial overlap between application of ORS 95.240 and 95.230, the four-year limit could apply in the case of an insider.

c. Ten Years. Oregon's statute of ultimate repose.

Beware equitable tolling for concealed transfers.

C. Transfers When Insolvent (or That Result in Insolvency): ORS 95.240

Only applies to present creditors.

D. Creditor Remedies for Fraudulent Transfers: ORS 95.260

Avoiding the transaction is just the beginning; transferees may be directly liable if the transferee has no knowledge that a transfer may be fraudulent.

E. Collateral Damage (Transferee Liability)

Many of the more egregious fraudulent transfer cases involve self-help transfers to unknowing or unsophisticated transferees. Often, the fraudulent transferor may end up causing greater harm to the very persons the transferor seeks to protect (typically spouses or children). Because of the nature of a defrauded creditor's fundamental remedy—avoidance of the transaction—a transferee's innocence may be largely irrelevant. Transferee liability can be harsh, although the court is granted substantial discretion in fashioning remedies and may not treat all transferees equally.

To start with, the plain statutory language is sobering:

> . . . [T]he creditor may recover judgment for the value of the asset transferred. . . . The judgment may be entered against:
>
> (a) The first transferee of the asset or the person for whose benefit the transfer was made; or
>
> (b) Any subsequent transferee.

ORS 95.270(2).

Yes, the statute says the transferee is liable for the value of the asset transferred at the time of the transfer. No, the statute does not provide any break for innocent transferees, not even innocent transferees who spent the fraudulently transferred assets on basic needs.

Courts may give some break to "innocent" transferees. See for example *Jones v. North West Telemarketing, Inc.*, 136 F. Supp. 2d 1166 (Dist. Or. 2001).

Good faith transferees for value (generally, good faith buyers or other creditors) are protected. ORS 95.270(5).

In so many cases, the transferee has knowledge of the fraud. Implicated transferees will get hammered. See for example *Thomas, Head and Greisen Employees Trust v. Buster,* 95 F. Supp. 1449 (9th Cir. 1996). Also, innocent transferees who are the transferor's family are likely to get hammered, even children. Consider three recent cases (as compiled by Jay Atkisson in "Asset Protection Hot Topics," *Southern California Tax & Estate Planning Forum,* October 2011).

✦ Fraudulent transfers to a debtor's children, who were apparently not minors but probably unaware of dad's financial troubles. Transfers included a Mercedes, rent payments, tuition, and living expenses. The debtor's children may be required to repay those amounts, even if most of the transferred funds have been spent and luxury items depreciated. However, there is some hint that the children, although unsophisticated and accustomed to a life of opulence, may have participated in the fraud, for example by accepting payments for personal expenses as compensation for nonexistent services rendered. *In re Innovative Communications Corp.* 2011 WL 3439291 (Bkrtcy D. Virgin Islands, 2011).

✦ Fraudulent transfers to spouse could pass for innocent, but the court appeared to conclude that she wasn't. Transferee spouse hit with judgment in excess of value of assets received. *Struyk v. Meltzer,* 2011 WL 1019916 (Cal App Dist 4, 2011). Note that a fraudulent transferee may not be able to seek discharge in bankruptcy for judgment resulting from fraudulent transfer.

✦ If a friend asks you to hold his assets for a little while, think about the last time you were in an airport and the TSA's recording advised you to call 911 if someone asks you to hold her bag/parcel for a little while, just for the flight. You don't want to be holding the bag when it blows up. Avoid assisting friends in defrauding creditors, or you may be liable along with your friend. *In re Mastro,* 2011 WL 4498834 (Bkrtcy WD Wash, 2011).

Statute of limitations in ORS 95.280 might be only safe harbor for transferees. If you receive a gift from your rich uncle, wait four years before spending it.

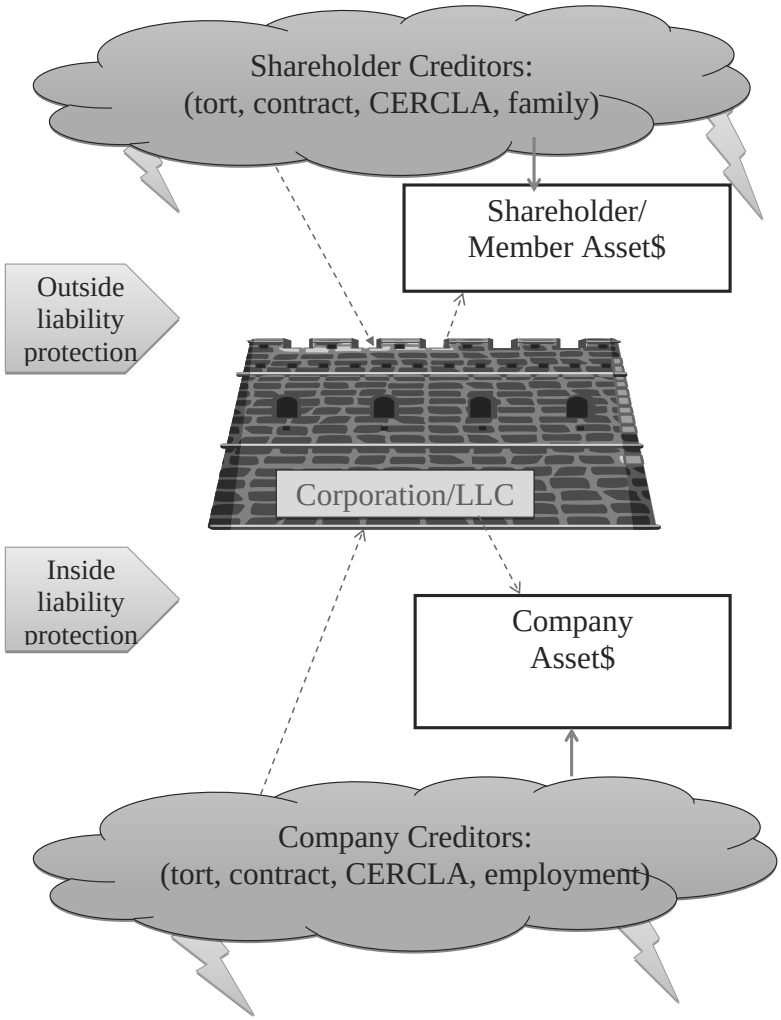
F. Basic Steps to Avoid Fraudulent Transfers

1. Start Early, Be Solvent. The client should be solvent both before and after implementing any asset protection planning. This means that the client is currently in a position to meet his or her obligations to creditors. In other words, don't become insolvent simply by reason of the asset protection transfers. Overall, the client needs to approach asset protection planning as a long-term, basic financial strategy of separating "family" assets from "business" assets—the more the debtor confuses those two, the more exposed each is to liabilities associated with the other.

Many business owner clients sign personal guarantees, even for trade debt. If possible, business owner clients may want to eliminate as many personal guarantees as possible before making transfers, even if they may eventually have to provide personal guarantees later. If personal guarantees are given after transfers, consider providing updated financial statements reflecting the debtor's reduced ability to pay.

2. Be Reasonably Well Insured, Capitalized. An indicium of intent to defraud creditors would be dropping ordinary insurance against ordinary risk, including professional liability.

3. Have Estate and Business Planning Motives for Taking Action. Most asset protection planning devices in fact have positive and ordinary uses in the estate and business planning area. Formation of a family investment LLC is a good example. Make sure that these are well documented.



III. LIMITED LIABILITY ENTITIES

A. Limited Liability: Inside and Outside Liability Protection

1. Inside Creditors. Creditors of the entity (limited liability keeps the creditors' claims bottled up "inside" the entity). In general, owners are not liable for debts of the entity. Protection of owners against liabilities of the venture is the classic purpose of limited liability entities—to allow risk-taking by capitalists.

2. Outside Creditors. Creditors of the owners of the entity (the liability is not the entity's and is therefore "outside" the entity). In general, entities are not liable for debts of their owners, but the owner's interest in the business is an asset potentially available to the owner's creditors. Restrictions on transfer of ownership interests, and on rights of owners to management and distributions, can provide protection against claims of the owner's creditors.

B. Inside Liability (Creditors of the *Entity* Who Want to Reach the Assets of the Owners)

1. General Rule: Limited Liability. Absent special facts circumstances, the owner or manager of an entity is not by reason of that ownership or management liable for the entity's debts. ORS 60.151, 63.165, 70.135.

2. Personal Fault. A limited liability entity does not protect an owner from the owner's personal fault. Even if activities are conducted in the name of a limited liability entity, the actor will remain personally liable for his or her personal fault. For owners who are closely involved in the management of risky activities or assets, the personal liability rule can eliminate much of the benefit of a limited liability entity.

A note about member-managed LLCs: a member who actively participates in management of a member-managed LLC may face personal exposure to claims that would in most circumstances be covered/limited by the workers' compensation exclusive remedy rule. In *Cortez v. Nacco Materials Handling Group, Inc. et al*, 2012 WL 758895 (Or App Feb. 29, 2012), a single-member LLC subsidiary (Sun Studs) was formed by Swanson Group, Inc., as a member-managed LLC. Apparently Swanson Group provided management services as member of the LLC. Based on what might be considered a technical oversight in the relevant statutes, the court found that members of LLCs are not protected by the workers' compensation statute, even in member-managed LLCs. The court drew an analogy to corporations, noting that shareholders are not protected by workers' compensation. The analogy is obviously not perfect, but the ruling stands.

Solution: never form a member-managed LLC, and convert any that exist. There are many other reasons to avoid member-managed LLCs, some relating to continuity of control but most relating to veil-piercing concepts. Swanson Group, Inc., could have served as manager if the LLC had been formed as a manager-managed LLC, and in that

case it should have been protected by workers' compensation even if Swanson Group, Inc., was also the sole member.

3. Personal Guarantees. Of course, a business owner is liable for debts of the business that he or she has personally guaranteed, and often our small to medium-sized business owner clients have been required to give guarantees. Note that owners' personal guarantees can work both ways, since bankruptcy of the guarantors/owners can often trigger loan acceleration clauses even if the company is current on payments.

4. Acting in Representative Capacity. To enjoy the limited liability protection of a limited liability entity for contractual obligations, the owner must inform potential creditors that he or she is acting as a representative (officer, manager, etc.) of the company and not in his or her individual capacity or capacity as a shareholder.

The reverse of representative capacity may be apparent agency authority (where a creditor reasonably, but not always correctly, believes the debtor was acting on behalf of another entity). For a scary-weird ride through the confluence of real property leasing and medical malpractice (where landlords are sued as doctors), see *Eads v. Borman et al.*, 234 Or App 324, *aff'd* SC S058445 (Or, April 26, 2012). If an entity called "Willamette Spine Center, LLC" owns a building and leases it to a medical group, can a plaintiff reasonably conclude that the physicians in the group are agents of the landlord? "We're Just Landlords Who Lease to Doctors, LLC" doesn't have much branding value, but it may have been less confusing to this patient's lawyers. Fortunately, the courts do not appear to have been confused.

5. Veil Piercing. In some cases an entity's "veil" of limited liability may be "pierced" by the entity's creditors, exposing the entity's owners to company liabilities.

a. In Oregon, the requirements for piercing the corporate veil as to a shareholder or shareholders are:

(i) The shareholder(s) must have controlled the corporation,

(ii) The shareholder(s) must have engaged in improper conduct in the exercise of that control, and

(iii) The shareholder's improper conduct must have caused the creditor to have no adequate remedy against the corporation.

"Improper conduct" may include gross undercapitalization, excessive distributions or diversion/draining of funds, misrepresentation of representative capacity, freezing out of minority shareholders, or failure to observe formalities. See for example *Hambleton Bros. Lumber Co. v. Balkin Enterprises, Inc.*, 397 F.3d 1217 (9th Cir. 2005).

Many veil-piercing cases involve bad actors who create thin disguises for failures to follow corporate formalities. They commingle funds, they fail to document corporate decisions or maintain corporate records, they sign in the wrong capacities as directors, officers, and shareholders—all of which are easily avoided by good counsel and careful process.

b. However, veil piercing as a result of inadequate capitalization can be a trap for even careful corporate operators.

Undercapitalization is a highly subjective concept and must be evaluated based on a variety of assumptions about future events. The basic rule is that a company's capital must be "adequate" to cover its "reasonably anticipated" liabilities. Where it is not reasonable to expect a company to be self-insured (by keeping large amounts of capital on hand), a company may meet its capitalization burden with insurance. Consider, for example, *Rice v. Oriental Fireworks Co.*, 75 Or App 627, *rev den* 300 Or 546 (1985). If there were ever a business that should consider adequate capitalization and insurance. . . .

A corporation must have sufficient capital to cover its reasonably anticipated liabilities, measured by the nature and magnitude of its undertaking, the risks attendant to the particular enterprise, and normal operating costs associated with its business. *Garner v. First Escrow Corp.* 72 Or App 715 (Or App 1985). Adequacy of capital is measured at the time a corporation is formed but can be reevaluated if excessive distributions of capital are made to shareholders.

Unfortunately, even though finders of fact are not supposed to judge adequate capitalization with hindsight, any analysis you might offer of adequate capitalization will be second-guessed after the fact.

Veil piercing may also take the form of treating shareholder debt as equity.

Oregon case law regarding piercing the corporate veil applies to piercing the LLC veil. *BDL Products, LTC v. Technical Plastics of Oregon, LLC*, 2006 WL 3628062 (Bkrtcy D Or).

C. Outside Liability (Creditors of the *Owners* Who Want to Reach the Assets of the Entity)

1. Fraudulent Transfers. Value received for transfer to limited liability entity is in question: if the transferor did not receive equivalent value, the transfer may be fraudulent, and the transferred assets returned to the creditor.

On one hand, the value of a noncontrolling interest in a closely held entity is likely to be subject to "minority" or "marketability" discounts that, immediately after transfer, reduce the value of the interest received below the value of the consideration paid, meaning that the transferor did not receive equivalent value.

On the other hand, contributing capital to a business venture is a common transaction, and many other investors in arm's-length transactions receive the same value back from contributions to limited liability entities, meaning that the transferor may have received "market" value in an arm's-length, good-faith transaction.

Instead, if the transfer is question is not a contribution to a limited liability entity but a sale of a noncontrolling interest in a limited liability entity at a "discounted" value, the value received may be "equivalent" for purposes of ORS 95.230(1)(b) and 95.240, because the asset transferred

is the minority entity interest, not a portion of the entity's assets. Think about an appraisal before the sale.

What happens to the innocent owners if a transfer by one owner to a limited liability entity is fraudulent?

As noted above, as transferee the entity may be required to return the contributed asset, or its value, which may be inconvenient for the other owners.

2. LLC Transfer Restrictions. Restricting transfer or acquisition of interests in limited liability entities is a core component of outside liability protection—protecting the entity's assets and business, and the interests of other owners, from an owner's creditors. Restrictions are imposed in three ways:

- ✦ Market restrictions (since in most cases no market exists for minority interests in closely held companies, ownership is often only valuable to a creditor if it allows the creditor to liquidate the company);
- ✦ Statutory restrictions (unauthorized transferees of LLC member interests become assignees); and
- ✦ Contractual restrictions (agreements among the owners as to transfer restrictions, purchase options, etc.).

a. Statutory Restrictions. Under ORS 63.249, membership interests are freely assignable, but unless the transferee is admitted as a member of the LLC in accordance with ORS 63.245, the transferee will be an "assignee" with respect to the assigned interest and will have limited rights (in general, an assignee will only have the right to receive the assignor's share of LLC distributions if and when made).

Because an assignee has no rights other than to receive distributions, an assignee may not have the right to seek dissolution of the LLC or otherwise bring "minority oppression" claims (but see difference when creditor is bankruptcy trustee, below).

ORS Chapter 63 does not provide a statutory form of preemptive rights, as is provided for corporations in ORS Chapter 60.

b. Contractual Restrictions (Buy-Sell Agreements). LLC members may agree as to restrictions on transfer of their member interests in an operating agreement. ORS 63.249. Few cases have considered LLC buy-sell agreements, but given courts' willingness to look at corporate precedent regarding limited liability, and given a lack of other precedent, it seems reasonable to rely on corporate and limited partnership law to interpret the effect of some LLC buy-sell agreements.

i. Basic rule: contracts are enforced as written unless unconscionable or otherwise unenforceable. A reasonably well-written buy-sell agreement is likely to be enforced. See for example *Kahn v. Weldin*, 60 Or App 365 (Or App 1982) (corporation), *Oregon RSA No. 6, Inc. v. Castle Rock Cellular of Oregon Ltd. Partnership*, 840 F.Supp. 770 (D Or 1993) (limited partnership).

Beware the court's equitable powers to adjust contractual terms to avoid unconscionable results, particularly regarding purchase price formulae. See *Francis v. Eoff Elec. Co.*, 127 Or App 632 (Or App 1994).

ii. Also beware involuntary transfers resulting from divorce. At a minimum, be sure that the buy-sell restriction expressly identifies transfers pursuant to divorce decrees as "involuntary" or otherwise a form of transfer that triggers the purchase option. In a truly arm's-length transaction, where the transferor/spouse receives no benefit from the forced sale, the purchase option may be upheld. For more certain results, consider special waivers from spouses of owners at the time operating agreements and buy-sell agreements are signed.

The status of Oregon law on this point is not entirely clear, but in general it appears that buy-sell agreements are enforced in the context of divorce, or that courts will take them into account as enforceable for purposes of determining the value of the business interest for purposes of dividing assets. See *Marriage of Kampmann*, 108 Or App 147 (Or App 1991); *Belt and Belt*, 65 Or App 606 (Or App 1983). See also *Durkee v. Durkee-Mower, Inc.*, 428 NE2nd 139 (Mass 1981), *Castonguay v. Castonguay*, 306 NW2nd 143 (Minn 1981).

c. Bankruptcy Trustee. Trustees in bankruptcy get to play by different rules.

i. Ipso Facto Clauses Void. In relation to LLC transfer restrictions, the bankruptcy trustee's power to acquire a debtor/member's LLC member interest—a transfer of the debtor's interest—cannot be restricted by statute or agreement. As a result, the bankruptcy trustee will likely be admitted as a full member, not as an assignee. Bankruptcy Code § 541(c).

ii. Executory Contracts. Contractual restrictions on transfers may be treated as executory contracts and as such may be rejected by the bankruptcy trustee. As a result, the trustee may be able to ignore buy-sell agreement terms that would otherwise restrict the trustee's transfer of the member interest. Bankruptcy Code § 365(e).

In Oregon, it is unclear whether an LLC operating agreement containing buy-sell provisions would be treated as an executory contract. In particular, see *In re Jack M. Miller,* Case No. 387-06351-P7 (Bkrtcy D Or June 25, 1991) (discussed in *Bankruptcy Law* (Oregon Legal Pubs 1999 with 2007 revisions, Ch. 10) (partnership agreements treated as executory contracts; debtor was general partner with substantial contractual obligations to partnership). But it does appear that in any event the bankruptcy trustee would succeed to the debtor/member's interest as existed at the time of bankruptcy and would not become an assignee.

A recent Arizona bankruptcy case found an LLC operating agreement containing buy-sell provisions not to be an executory contract and therefore to be binding on the bankruptcy trustee. The buy-sell restrictions could not prevent the trustee from becoming a member, with all rights held by the debtor/member at the time of bankruptcy, but since the debtor/member was party to the buy-sell agreement at the time of bankruptcy, the trustee also took the membership interest subject to the buy-sell agreement. *In re Ehmann,*

319 BR 200 (2005). The court in *Ehmann* noted that both operating agreement restrictions and statutory restrictions (assignee status) were "ipso facto" clauses and ineffective in relation to the debtor's transfer to the bankruptcy trustee. See ARS 29-732. A similar result was reached in *In re Baldwin,* Case No. 06-7083 (10th Cir. Jan. 26, 2010), and in *In re ASK Investments, Inc.*, No 95-30780TDM (Bkrtcy D Nor Cal Dec. 14, 1998).

If an operating agreement is found to be an executory contract, and as a result a bankruptcy trustee is not bound by its terms in transferring the debtor's member interest, statutory restrictions on such transfer should still apply. Under ORS Chapter 63, all the trustee can transfer is an assignee's interest, unless the other members agree to admit the assignee as a member. ORS 63.249, 63.245. A bankruptcy trustee's first inclination may be to seek dissolution or sale of the LLC, as illustrated in all of *Marks, Ehmann,* and *Baldwin.* To avoid dissolution in those circumstances, the LLC will need to be respected as a meaningful business entity. The LLC members should make the same efforts to maintain the LLC's separate existence, demonstrate a business and/or estate planning purpose of the LLC, and adequately capitalize the LLC, as are generally advisable for tax planning and limited liability protection purposes.

d. Concerns. The confluence of concerns in managing LLCs for asset protection, valuation planning, and limited liability can be overwhelming. But all of these concerns are generally resolved by one set of rules.

i. Maintain the entity's separate existence.

✦ Formalities, representative capacity, no commingling.

ii. Demonstrate and document meaningful business and/or estate planning purposes for the entity, and "justify" its continued existence as other than an asset protection or tax device.

Active business; investment fund. Consider comparable funds and companies as guidelines.

iii. Adequately capitalize the entity.

✦ Capital on hand for reasonably anticipated expenses and liabilities, plus adequate insurance for contingencies.

3. Single-Member LLCs. Single-member LLCs offer no protection against outside liabilities of the member. ORS 63.245(2)(c), Bankruptcy Code § 541(c). If a bankruptcy trustee becomes the member, the trustee can control liquidation and distributions. If another creditor becomes an assignee and there are no other members, the assignee is automatically admitted as a member under ORS 63.245(2)(c).

IV. TRANSFERS TO SPOUSE

A. Outright Transfers

In general, a spouse is not liable for the debts or obligations of his or her spouse in the absence of a specific undertaking See ORS 108.040–108.060; ORS 108.080; and ORS 108.090. See also *Alldrin v. Lucas,* 260 Or 373 (Or 1971). The usual risk associated with this strategy is

domestic conflict or dissolution of the marriage and of course UFTA. In general, if the assets were acquired as a marital asset (and in the absence of a premarital agreement), they may be on the table for division at dissolution anyway. Accordingly, as long as the spouse does not have a need for asset protection planning, these sorts of estate planning transfers to spouses should be considered.

B. Tenancy by the Entirety

This form of ownership (which exists only between spouses as to real property) has a peculiar advantageous set of legal parameters. In particular, while both spouses are alive and married, neither can divide or defeat the tenancy by the entirety which allows concurrent use or occupancy of property and provides a remainder interest in the surviving spouse as property, the creditor can't force a partition of the property, may be entitled to occupy the property (along with the other spouse), and must wait until the death of one of the two spouses to know whether the debtor is entitled to the whole thing or none of it. Note that a joint tenancy in personal property can be severed by either party and therefore provides no protection. ORS 105.920.

A trustee in bankruptcy may sell both the debtor's interest *and* the interest of any co-owner in property in which the debtor had an undivided interest as a tenant in common, joint tenant, or tenant by the entirety if: (1) partition is impracticable; (2) sale of an undivided interest would realize significantly less than a sale of a partitioned interest; (3) the benefit of a sale outweighs the detriment to such co-owners; and (4) the property is not used for the production of energy. See 11 U.S.C. § 363(h), *In re Rerisi Bkrtcy,* E.D. N. Y. 1994, 172 B. R. 525 (1999).

V. RETIREMENT ACCOUNTS, LIFE INSURANCE

A. Retirement Accounts/Plans

Oregon offers excellent asset protection for 401(k) plans, IRAs, and a variety of pensions (such as PERS), making all such accounts valid self-settled spendthrift trusts, without dollar limitation, even on noncompensatory retirement accounts (nonemployer IRAs, etc.). ORS 18.358. So max out your 401(k) and IRA contributions first. Note that Oregon's statute (and perhaps no state statute) specifically mentions inherited IRAs, and the language of Oregon's statute could be read to apply to all "individual retirement accounts," thus including inherited IRAs.

Again, bankruptcy trustees get to play by special rules, and they may cap protected assets at $1 million. However, the $1 million cap does not apply to employer plans or rollovers from employer plans. Bankruptcy Code § 522.

Retirement account contributions are not excluded from UFTA: ". . . Congress intended to provide protection against the claims of creditors for a person's interest in pension plans, unless vulnerable to challenge as fraudulent conveyances or voidable preferences." *Velis v.*

Kardanis, 949 F2d 78 (3d Cir 1991), *In re Hoist*, 192 BR 194, 199 (Bankr. ND Iowa 1996).

But courts may be inclined to protect IRAs and other retirement accounts from UFTA, so long as the transferors respect the IRA funding and distribution rules, and so long as the IRA transfers are not disguised or concealed. See for example *In re Channon*, 424 B.R. 895 (Bkrtcy D NM, 2010). "Excess" contributions are very likely to be subject to UFTA (in *Channon*, the debtor only transferred $10,000 to IRAs). Given Tax Code limitations on contributions to IRAs, you can only take this form of post-claim self-settled planning so far.

B. Life Insurance

Life insurance on a debtor's life that is not payable to the debtor's estate is not subject to the claims of the insured/debtor's creditors, even if the debtor was the owner of the policy. ORS 743.046. Note, however: subject to the statute of limitations, the amount of any premiums paid in fraud of creditors for such insurance, with interest thereon, shall inure to their benefit from the proceeds of the policy. ORS 743.046(4).

VI. DECEDENTS' ESTATES

A. The "*Olesberg* Fix"

SB 387, ORS 107.105(1)(f)(D) (effective January 1, 2012).

Are inheritances no longer marital assets? *Olesberg* clarifies and should reduce judicial speculation into the intentions of donors and testators, but the facts and circumstances of such cases rarely allow a court to isolate the question of inheritance.

For an excellent summary of recent cases (pre-*Olesberg* fix), see Lisa Bertalan and Melissa Lande, "How to Avoid Unintended Consequences of Estate Planning in Dissolution Court," *OSB Estate Planning and Administration Section Newsletter*, April 2009.

B. Decedent's Creditors' Rights to Reach Nonprobate Assets

If it's not part of the probate estate or revocable trust, is it subject to claims of the decedent's creditors?

For an excellent summary of the state of Oregon law on this subject, see Daniel C. Re, "The Right of an Unsecured Creditor to Recover from a Decedent's Nonprobate Property," *OSB Estate Planning and Administration Section Newsletter*, January 2009.

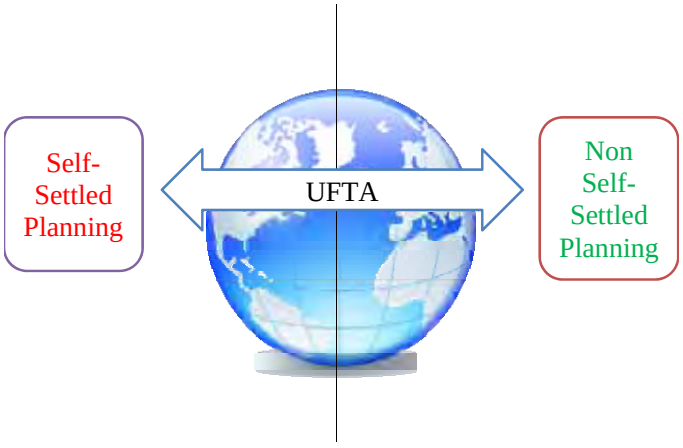
APPENDIX—PRESENTATION SLIDES

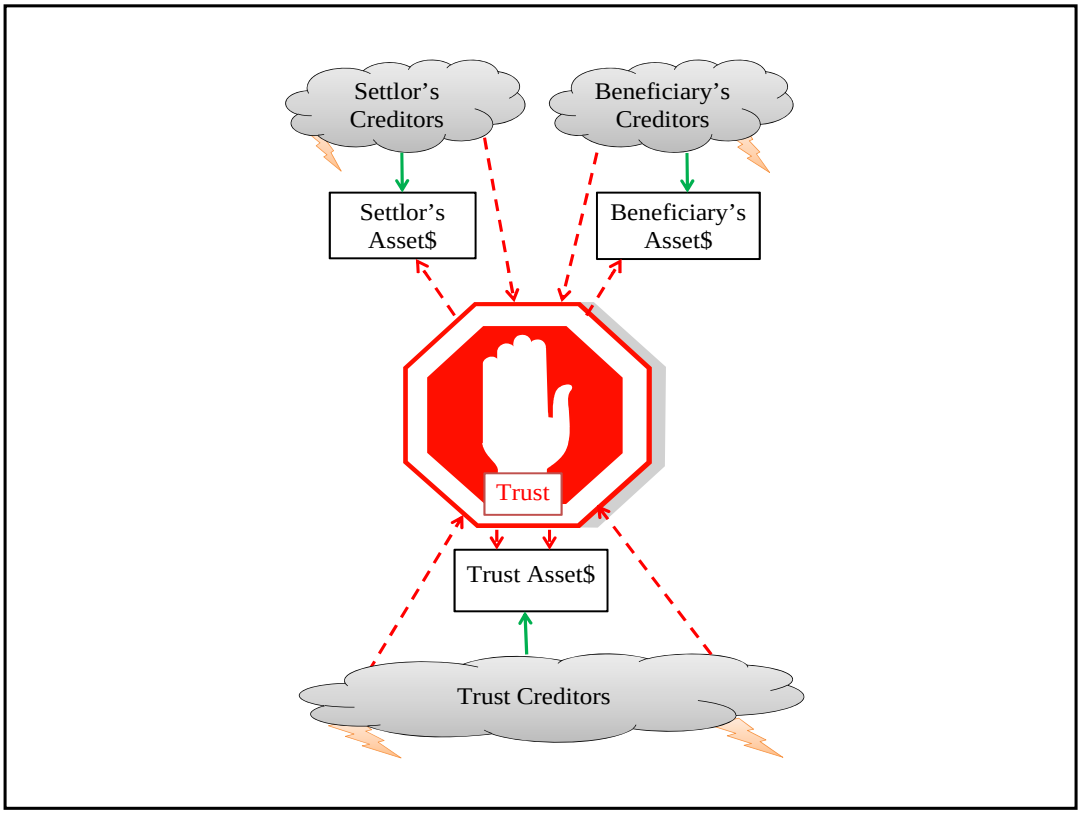
Asset Protection Planning Basics

Estate Planning and Business Transactions

Ian T. Richardson
Gleaves Swearingen LLP
June 22, 2012

Two Worlds of Asset Protection Planning

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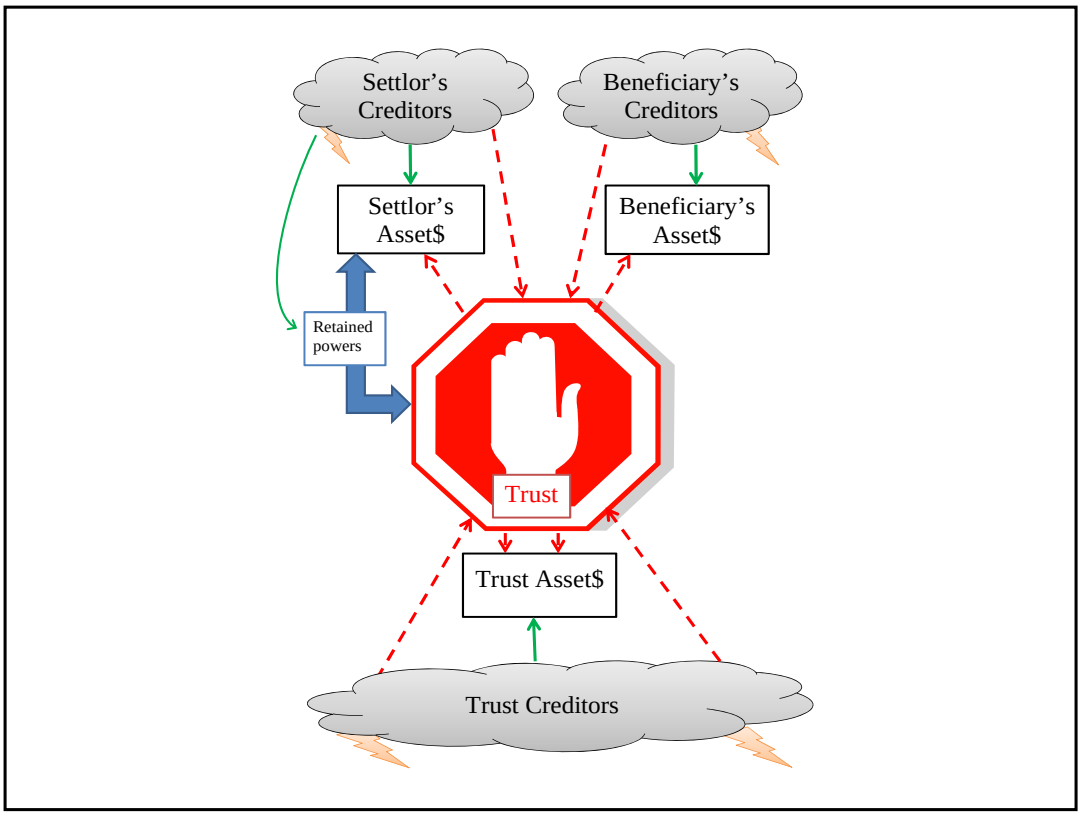
Beneficiary's Creditors
Settlor's Asset$
Beneficiary's Asset$
Trust
Trust Asset$
Trust Creditors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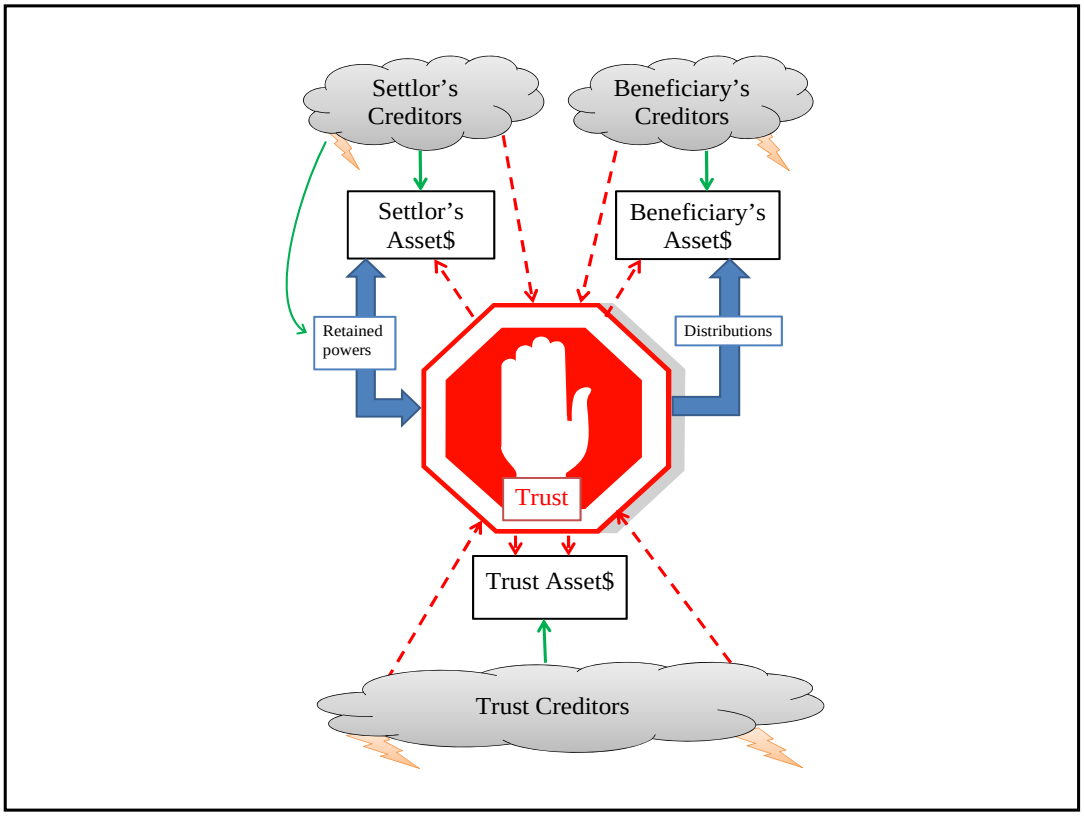
Beneficiary's Asset$
Retained powers
Trust
Trust Asset$
Trust Creditors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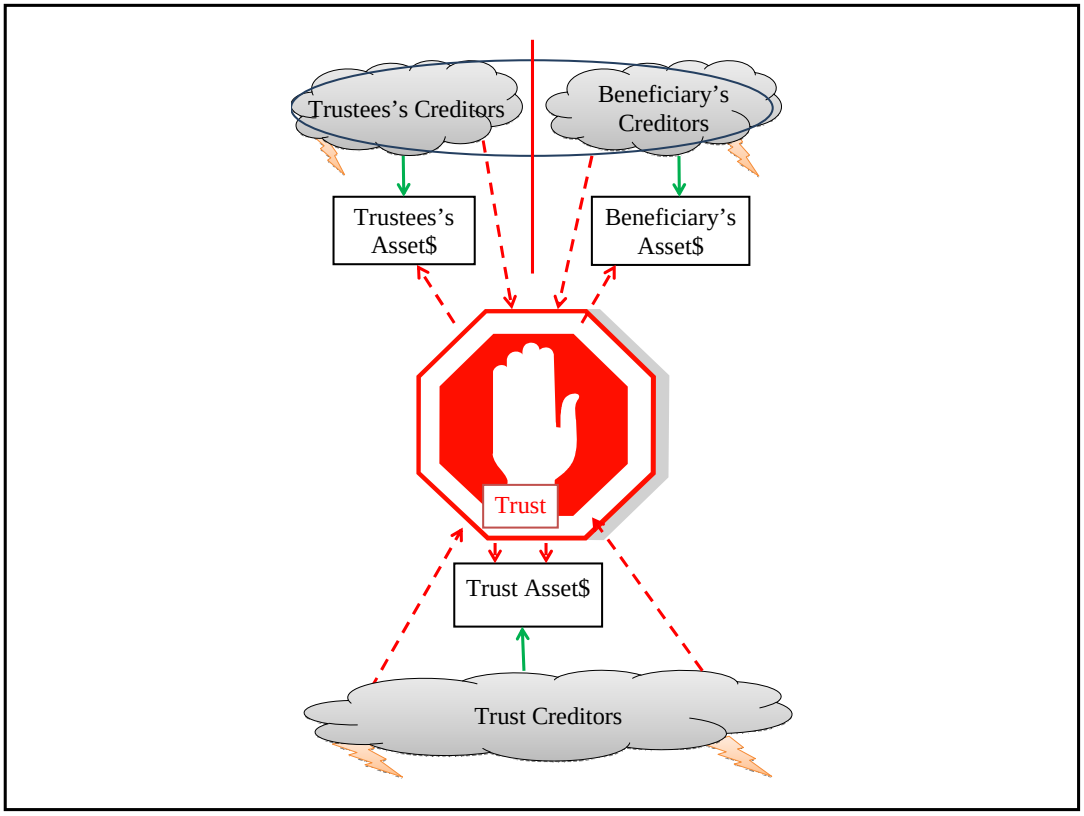
Beneficiary's Asset$
Retained powers
Distributions
Trust
Trust Asset$
Trust Creditors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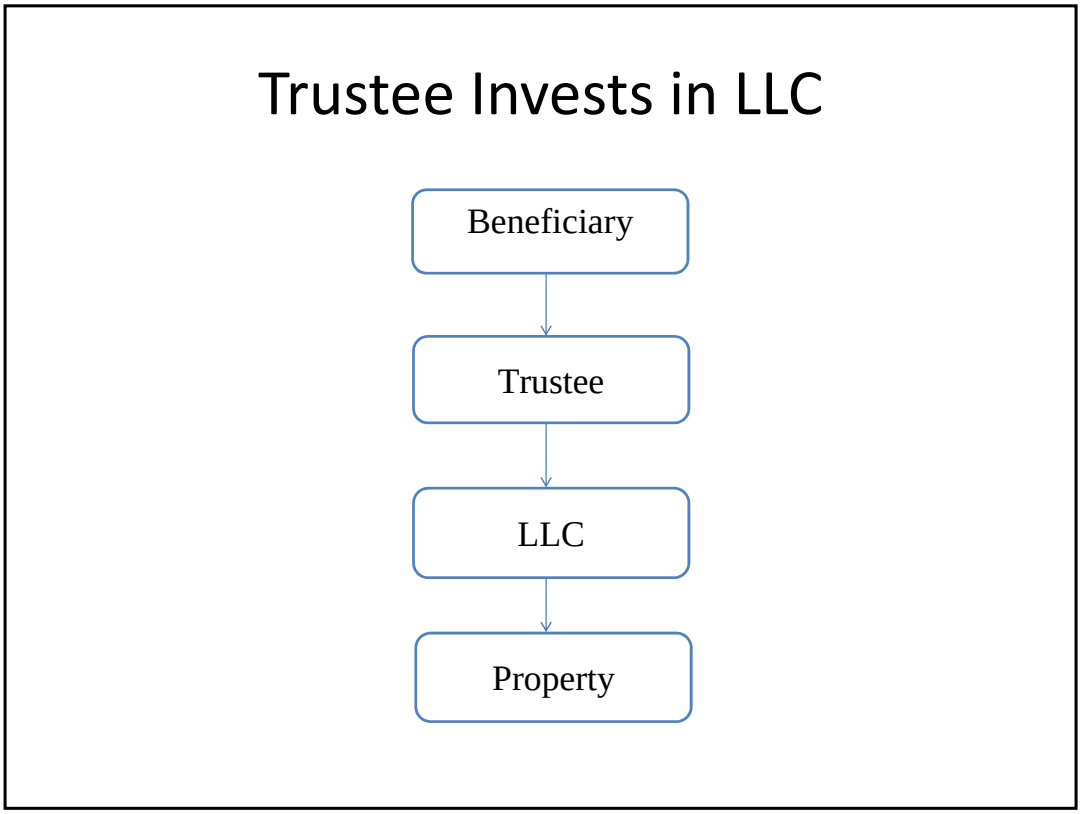
Beneficiary's Creditors
Trustees's Asset$
Beneficiary's Asset$
Trust
Trust Asset$
Trust Creditors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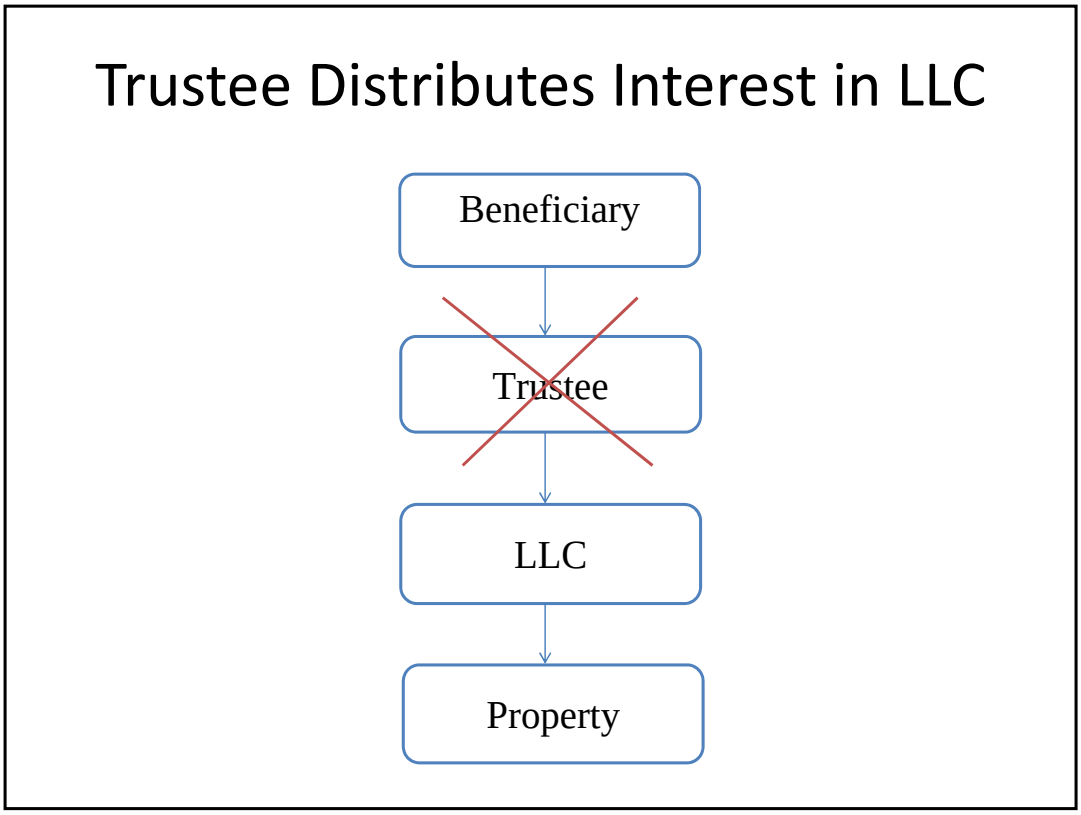
Beneficiary
Trustee
LLC
Property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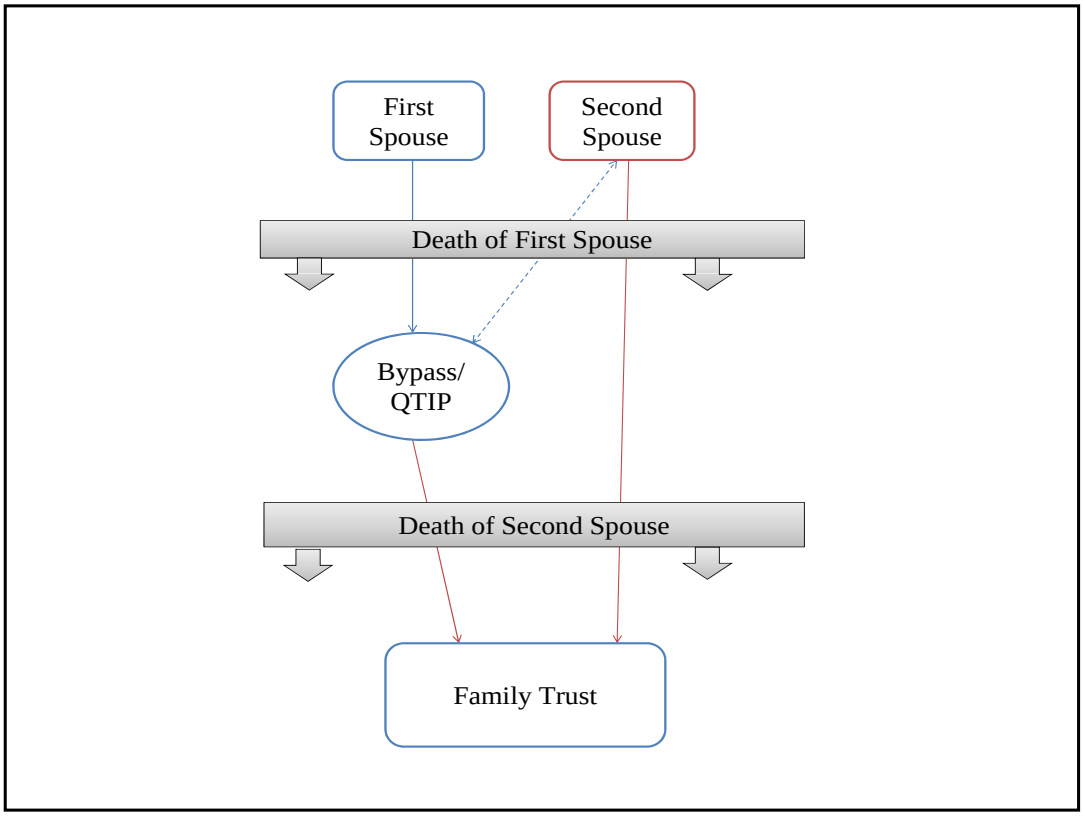
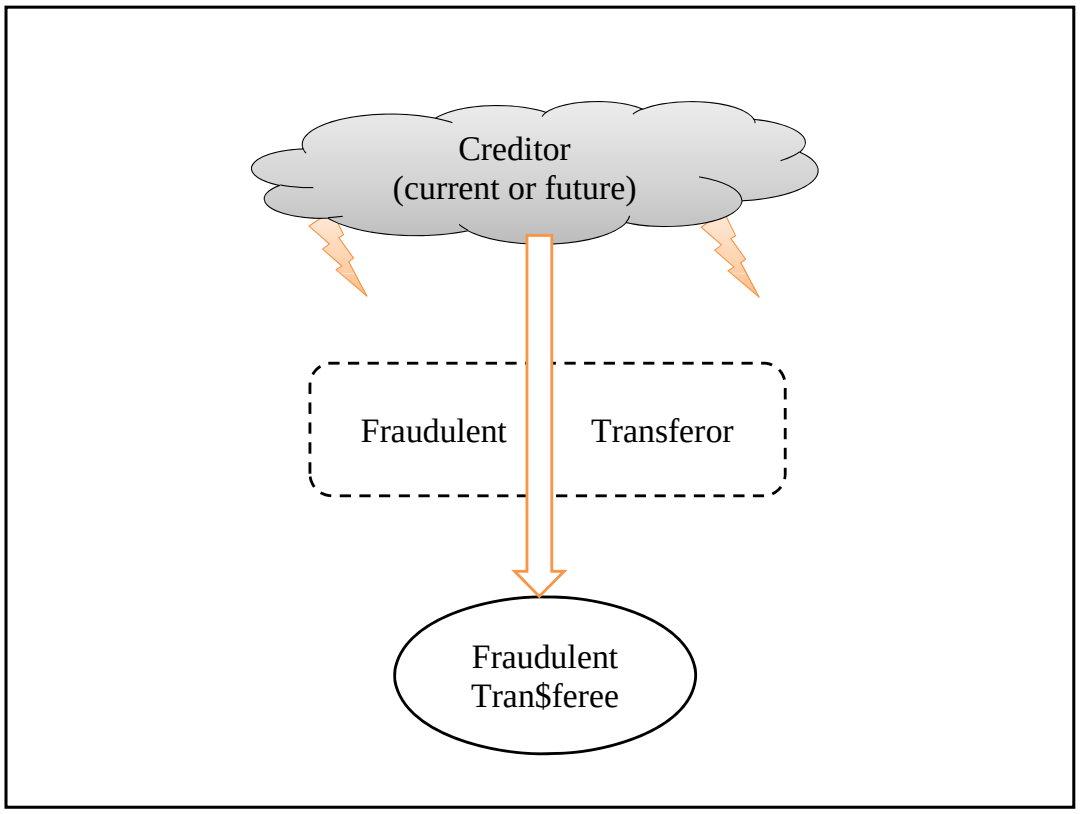
Beneficiary
Trustee
LLC
Property



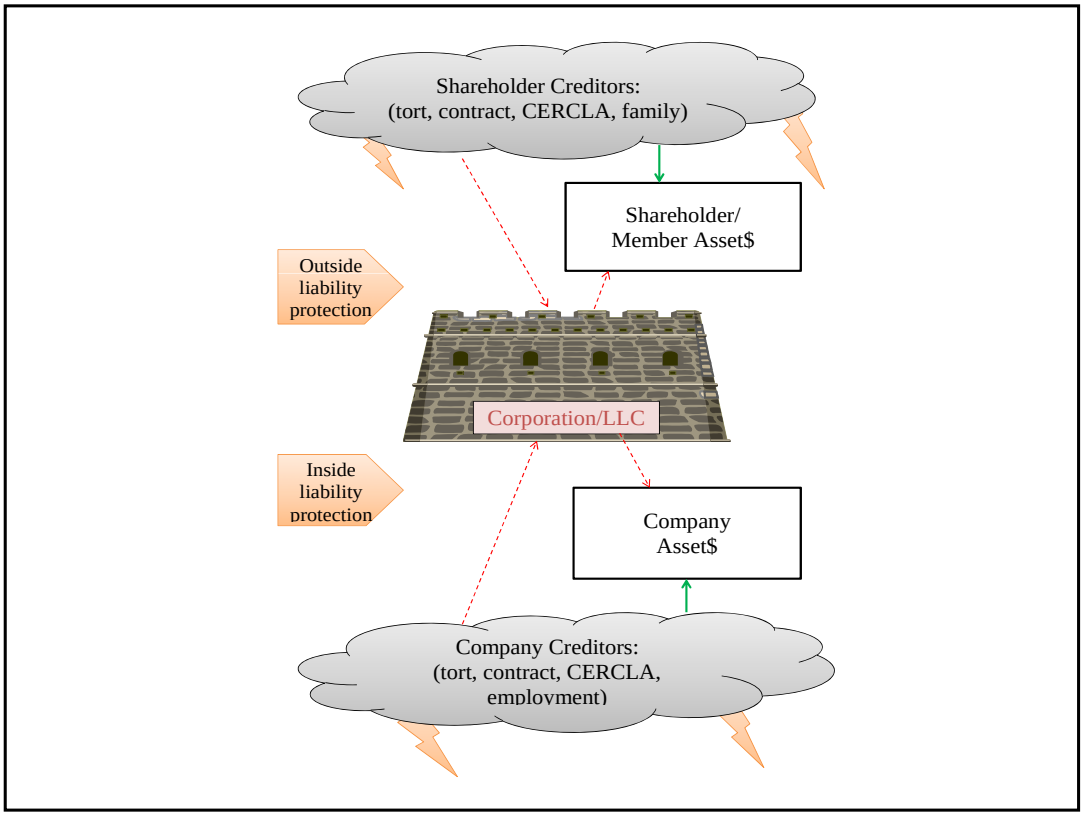
Uniform Fraudulent Transfer Act

- Actual Fraud (ORS 95.230(1)(a))
  - Specific creditor
  - Badges of Fraud
- Constructive Fraud (ORS 95.230(1)(b))
  - Less than value, risky business
- UFTA Creditors
  - Present creditors
  - Future creditors
  - Potential future creditors



Basic Steps to Reduce Fraudulent Transfers

- Start Early, Be Solvent
  - Before and after transfer
  - Watch PGs, latent liability
- Be Adequately Capitalized, Insured
  - In light of business risks
- Have Estate and Business Planning Motives
  - Maintaining control over transferred assets
  - Consolidated management
  - Provide benefits for family members

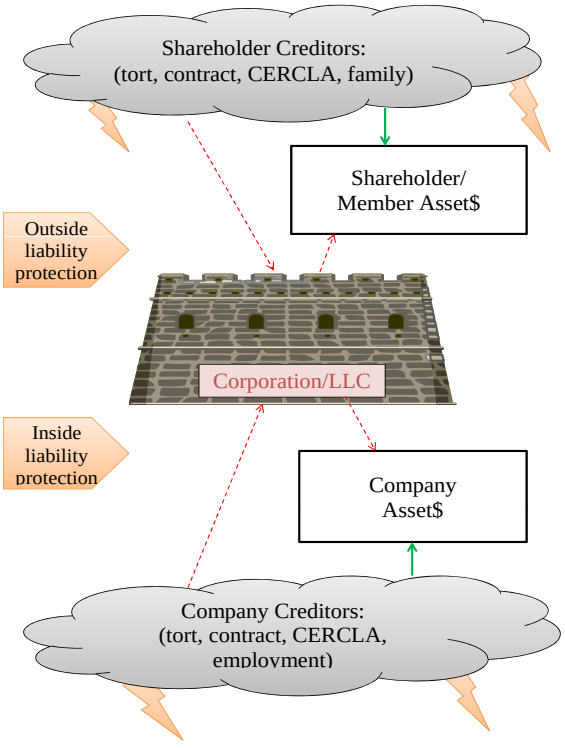


LLC Transfer Restrictions

- Statutory Restrictions
  - Assignee status
- Contractual Restrictions (Buy-Sell Agreements)
  - Right of first refusal
  - Call right on involuntary transfer
  - Put rights on death, retirement
  - Tag-drag, antidilution, etc.

Transfer Restrictions in Bankruptcy

- Ipso Facto Clauses Void (sec. 541(c))
  - Statutory and contract restrictions not effective against transfer to bankruptcy trustee
  - Bankruptcy trustee may take member interest subject to buy-sell
- Executory Contracts (sec. 365(e))
  - Bankruptcy trustee can reject, sell without contractual restriction
  - Statutory restrictions still apply



LLC Rules for Asset Protection, Valuation Planning, Limited Liability

- Maintain entity's separate existence
  - Formalities, comingling, representative capacity
- Demonstrate meaningful estate and business planning purposes
  - Business purpose, estate planning purpose, no sham transactions
- Adequately capitalize and insure entity
  - Cash on hand for reasonably anticipated expenses
  - Insurance, including major loss

IRAs and Life Insurance Benefits

- IRAs and Pensions
  - GOOD! (Oregon's self-settled trust)
  - Watch UFTA (contributions, especially excess contributions)
- Life Insurance Death Benefits
  - GOOD! (not available to decedent/insured's creditors)
  - Watch UFTA (payment of premiums)

Chapter 4

RETIREMENT PLAN DESIGNATIONS—PLANNING FOR AMERICA'S LARGEST INVESTMENT ASSET

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RETIREMENT PLAN DESIGNATIONS: PLANNING FOR AMERICA'S LARGEST INVESTMENT ASSET[1,2]

By

Ronald A. Shellan[3]

1. Introduction. Outside of a person's home, retirement plans are America's most valuable asset. And of course, retirement plans are the primary source of wealth not only for retirement, but also for passing on wealth to family members.

The designation rules for qualified retirement plans are a very complicated stew. So why are the designation rules so completely confusing? Congress has left most of the rules to be determined by the Internal Revenue Service. Plan administrators have always pressured Congress and the IRS for easy-to-follow rules that minimize the chance of error. No one would want to claim parentage for this jumble of rules. Yet these are the rules that plan participants and beneficiaries must deal with.

This article is not a textbook on retirement tax issues. It is intended to provide a working knowledge of the tax rules so that they can be used advantageously in estate planning. In reading this article, note that many defined contribution plans (such as 401(k) plans) do not allow many types of

[2] This document should not be construed as legal advice or legal opinion on any specific facts or circumstances. The content is intended for general informational purposes only, and you are urged to consult a lawyer concerning your own situation and any specific legal questions you may have.

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long-term payouts to family members or others following the death of the participant. But these plans can be rolled over tax-free following death to an "inherited IRA." Thus, IRAs and other types of retirement plans (but not Roth IRAs) are generally discussed interchangeably.

1.1 **Goals.** In financial and estate planning, almost everyone wants to achieve a number of goals. The estate plan must consider not only personal considerations (such as competency of beneficiaries), but also income and estate tax considerations. And—you guessed it—these goals often conflict with each other.

1.2 **Harry and Sally.** In the quest to help explain the rules, we will be dealing with our sometimes happily married couple Harry and Sally. In most examples, Harry is 74 years old and owns a substantial IRA. Sally is 12 years younger than Harry and is 62. Between them, they have two adorable children, Jack and Jill. Jack is 15 years older than Jill. Harry in most examples owns an IRA that has been funded with pretax dollars. The original owner of an IRA or a participant in a retirement plan is referred to in this article as the "participant." The person who will take after the death of the participant is referred to in this article as the "beneficiary" or "beneficiaries." And if a beneficiary dies before the funds in the plan are fully withdrawn, the beneficiary's own beneficiaries are referred to as the "successor beneficiaries." In some of the examples, the children will be Harry's children from a prior marriage. Our discussion will generally assume that the husband, or Harry, dies first. When Harry first met Sally, he never dreamed that planning for the distribution of his IRA could be so complex.

1.3 **Stretching Benefits.** For wealthier individuals, reducing income taxes from retirement plan distributions is a very important goal. For most assets, if the participant holds the asset at death, the asset will receive a new tax basis. For example, if Harry purchased a house for $200,000 and it is worth $1 million at his death, its new tax basis for the purpose of determining gain or loss in the hands of Harry's beneficiaries is $1 million.[4] So if Sally was Harry's sole beneficiary and received the house from Harry's estate, she could sell the house for $1 million without recognizing any taxable gain. Not so for retirement plans. They are known as Income in Respect of a Decedent[5] assets, which means that if Harry had a $1 million IRA and designated Sally to receive the funds at death, and the plan funds were distributed to her because the retirement account does not receive a step up in basis on Harry's death, she would have $1 million of taxable income.

Thus, many wealthier individuals also have as a goal deferring the time when funds are distributed from the plans to allow more tax-free buildup within the plans and to delay the date on which the funds are subject to income taxes. This concept is known as "stretching" the benefits. Retirement plan benefits for many participants need to be paid out within certain time limits (generally, beginning at age 70½). The minimum payment that must be paid each year is known as the Required Minimum Distribution (sometimes referred to as "RMD"). Depending on how a beneficiary designation description is made, the RMD can be a very short period of time. For example, if the

[4] IRC § 1014.
[5] IRC § 691.

designation for Harry's IRA is to his estate, the RMD requires withdrawal of (and paying tax on) all the retirement funds within five years following Harry's death. Alternatively, the funds might be eligible to be paid out over a much longer period of time. Stretching out the RMD is one of the primary goals when planning for retirement plan distributions and designations.

1.4 **RMD Questions.** A schedule summarizing the Required Minimum Distribution rules for retirement plans and IRAs can be found at the end of this article. A second schedule showing the RMD rules for Roth IRAs is also included. In order to determine the RMD applicable to any situation, just a few questions need to be answered:

1.4.1 Is the plan beneficiary a surviving spouse, an individual who is not a spouse, or a nonperson (such as an estate, a charity, or a trust)? Note that certain types of trusts qualify to be treated as persons for purposes of this rule.[6]

1.4.2 What is the required beginning date on which the plan benefits must first be paid out to beneficiaries? The commencement date is important because the later the commencement date, the later that income tax obligations will be due.

1.4.3 If the plan's designated beneficiary is to one or more persons, whose life is used to measure the payout? In some cases it will be the participant. In some cases it will be the beneficiary. If there is more than one beneficiary, the

[6] See Section 8.

Required Minimum Distribution will be based on the life expectancy of the oldest beneficiary. If all the designated plan beneficiaries are individuals, the plan has Designated Beneficiary status. This is a very important concept that is closely tied in with whose life is used in determining the RMD. If an estate, most trusts, charities, or other nonpersons are potential contingent, remainder, successor, or power-of-appointment beneficiaries, the designation may well not be treated as a Designated Beneficiary. In that case, the plan benefits generally need to be paid out within five years of the participant's death. The Designated Beneficiary can be altered after the death of the participant by paying off a beneficiary or by a beneficiary's disclaiming his or her interest in the IRA. Another common postdeath strategy is to establish separate IRAs for each beneficiary. If a separate IRA is established for each IRA, it will generally result in separately analyzing each IRA as to its Designated Beneficiary status. The Designated Beneficiary concept is more fully discussed below.[7]

1.4.4 Provided that the payout is made only to individuals, which life expectancy table is used to compute the payout?

1.5 **RMD Basics.** Mastering how the Required Minimum Distribution rules work is the necessary first step in being able to make the right choice for planning for the distribution of retirement benefits. This article is divided into two primary sections. The first part of the

[7] See Section 10.

article reviews the three tables used for calculating the RMD. It also discusses the RMD for participants, surviving spouses, other individuals, and nonpersons (such as certain trusts). The rules are important as there is a 50 percent penalty for failing to withdraw the full RMD.[8] These rules are referred to below as the Participant RMD Rule, the Spouse RMD Rule, the Individual RMD Rule, and the Default RMD Rule. The second part applies the rules to specific fact situations faced by many people when completing their estate planning.

In general, a participant must begin withdrawing benefits at age 70½. If a participant dies after starting to take out his benefits, the participant's beneficiary generally must take out the remainder of the retirement assets over the beneficiary's remaining actuarial lifetime. A surviving spouse can elect to roll over an IRA she inherits to a new IRA in which she is treated as the participant.

The following rules apply to withdrawals if the participant dies before age 70½. A surviving spouse can wait until she is 70½ to commence withdrawing retirement benefits. They must be withdrawn over her lifetime. A surviving spouse can also elect to roll over the retirement benefit to a new IRA in which she is treated as the participant. If children or other individuals are named as the beneficiary of the retirement benefits, they must withdraw the funds beginning the year after the death of the participant over the life expectancy of the oldest beneficiary. Finally, if the distribution of the retirement benefits is to

[8] IRC § 4974.

a nonperson, the distribution must be withdrawn within five years of the death of the participant.

Generally, distributions of retirement benefits to estates, trusts, and charities are treated as distributions to nonpersons. But a trust can be treated as a person if certain rules are met, the most important of which is that each of the trust's beneficiaries are persons. Unfortunately, this can include potential contingent, remainder, successor, and power-of-appointment beneficiaries, which might include nonpersons or much older individual persons. But there is an exception if all of the plan distributions received by the trust must be distributed annually to the trust's beneficiaries. In that event, potential beneficiaries are ignored and the current income beneficiaries count for purposes of determining potential ages of beneficiaries and whether the beneficiaries are persons or nonpersons.

2. Life Expectancy Tables. If the RMD is based on the actuarial life of a person, one of three different life expectancy tables must be used. The tables are set forth in the regulations.[9] It is important to look at how different the results can be based on which life expectancy table is used. For example, the Required Minimum Distribution for a $100,000 IRA based on the life of a 74-year-old person under the Uniform Lifetime Table is $4,201 and under the Single Life Table is $7,092.

2.1 **Uniform Lifetime Table (For Most Participants).** The Uniform Lifetime Table is based on the joint life of the participant and a beneficiary who is ten years younger than the participant. It is used to

[9] Treas Reg § 1.401(a)(9)-9.

calculate a participant's RMD unless the participant's spouse is the sole primary beneficiary of the retirement plan and the spouse is more than ten years younger than the participant. RMD is redetermined each year beginning the year after the participant reaches 70½. For example, if there is $100,000 in Harry's IRA, and Harry is 74, his distribution period is 23.8 years. Thus, he must withdraw $4,201 ($100,000 / 23.8). The next year when Harry is 75, and the account balance has grown to $101,000, he must make an RMD based on a 22.9-year distribution period. Thus, his RMD is $4,410 ($101,000 / 22.9). The account will never be exhausted during Harry's life as long as he withdraws only the minimum Required Minimum Distribution, because no matter how old Harry is, he has a life expectancy that is greater than one year. The process of annually redetermining the actuarial life expectancy of the measuring life is referred to as the "Recalculate Annually Method."

2.2 **Joint and Last Survivor Expectancy Table (For Participants Whose Spouse Is at Least Ten Years Younger).** The Joint and Last Survivor Table is for a married participant who names his spouse as the sole primary beneficiary and that sole primary beneficiary is more than ten years younger than the participant. Each year, the distribution period is recalculated based on combined life expectancy of the participant and his spouse using the Recalculate Annually Method. During Harry's life, if only the RMD is withdrawn, the account will never be exhausted.

2.3 **Single Life Table (Used Following Participant's Death).** The final life expectancy table used in the regulations is the Single Life Table.

It is used to determine the RMD following the death of a participant for a surviving spouse (but only if she does not roll over to a new IRA) or individual other beneficiaries (such as children). If the surviving spouse is the sole primary beneficiary, she can use a special calculation method each year to determine the RMD based on her remaining life using the Recalculate Annually Method.[10] Thus, a surviving spouse who withdraws only the Required Minimum Distribution can never exhaust the funds in the retirement plan because she will always have a life expectancy of at least a year. This is not the case for other beneficiaries. For example, if Harry died and designated Jill as his beneficiary, this table would be used by Jill. She would be required to withdraw the funds based on her age. If Jill was 16 the year after Harry died (benefits must generally commence by December 31 of the year following the participant's death), her distribution period would be 66.9 years. If the IRA had a balance of $100,000, she would have an RMD of $1,495 ($100,000 / 66.9). Each year thereafter, the divisor is reduced by 1. The next year, if the account had $101,000 in it, the RMD would be $1,532 ($101,000 / 65.9). Thus, the account will be exhausted in 67 years when Jill is 83. The method of deducting 1 from the divisor each year will be referred to as the "Reduce by 1 Method."

3. RMD for the Plan Participant.

What follows is an explanation of the Required Minimum Distribution for a retirement plan other than a Roth IRA. The plan participant can withdraw funds at any time, of course. If the participant is younger than 59½, in

[10] Treas Reg § 1.401(a)(9)-5, Q&A A-5(c)(2).

addition to paying regular income taxes on the withdrawal, there is a 10 percent penalty. After age 59½, the funds can be withdrawn without penalty.[11]

But what is the RMD for the plan participant who wants to take maximum advantage of the tax-free buildup of plan assets within the plan? The commencement date when funds must begin to be withdrawn is April 1 of the year following the year in which the participant reaches age 70½.[12] For employees who have not retired by age 70½, who have an employer retirement plan (not an IRA), and who are not 5 percent or greater owner of the company, the commencement date is April 1 of the year following retirement.[13] The RMD is based on the Uniform Lifetime Table applying the participant's life expectancy and using the Recalculate Annually Method. But if the participant is married, and his spouse is the sole primary beneficiary of the plan at the participant's death, and the spouse is more than ten years younger than the participant, the RMD would be based on the Joint and Last Survivor Table using the Recalculate Annually Method. In the year of death, the participant does not get a break. If the participant did not withdraw the Required Minimum Distribution while he was alive, his estate must make sure that it is withdrawn by the end of the calendar year.

4. RMD for Surviving Spouse ("Spouse RMD Rule").

The surviving spouse is a favored beneficiary in many ways. The following paragraphs discuss the RMD for a surviving spouse for retirement plans other than a Roth IRA. Congress has provided quite a number of special

[11] IRC § 72(t).
[12] IRC § 401(a)(9)(C).
[13] Treas Reg § 1.401(a)(9)-2, Q&A A-2(a).

benefits for surviving-spouse plan beneficiaries that are not available to other beneficiaries.

4.1 **Surviving Spouse Inherits Plan.** At the death of the plan participant, the surviving spouse (or other beneficiary) can withdraw all the funds without penalty even if she is under age 59½.[14] If the surviving spouse is the sole primary beneficiary, and the participant died before age 70½, she must commence distributions no later than December 31 of the year in which the participant would have been age 70½. The RMD will be based on the surviving spouse's life. If the participant died after he was 70½, the Required Minimum Distribution payments must commence by December 31 of the year following the death of the participant.[15] In that event, the RMD is based on the age of whoever is younger, the participant (assuming that he was alive) or the surviving spouse. In all events described above, the Required Minimum Distribution would be based on the Single Life Table using the Recalculate Annually Method.

On the surviving spouse's death, if the successor beneficiaries are her children or other persons (but not to a nonperson, such as an estate, a charity, or some trusts), the successor beneficiaries must commence withdrawing funds by December 31 of the year following the surviving spouse's death. For RMD purposes, the measuring life would be the surviving spouse's life. Distributions would be based on the Single Life Table using the Reduce by 1 Method. If both the

[14] IRC § 72(t)(2)(A)(ii).
[15] Treas Reg § 1.401(a)(9)-3, Q&A A-4.

spouse and the participant did not live to age 70½, however, the measuring life would become the oldest Designated Beneficiary.

4.2 **IRA Rollover: A Better Stretch.** An alternative approach available only to the surviving spouse, as long as she is the sole Designated Beneficiary, is to roll over the retirement benefits into a new IRA (or elect to treat the inherited IRA as a new IRA[16]). The advantage to the surviving spouse is that this is treated as a brand-new IRA.[17] The required beginning date for a new IRA is the date that the surviving spouse reaches age 70½. The measuring life is the surviving spouse, and the RMD is based on the Uniform Lifetime Table (using the Recalculate Annually Method), which has a much lower RMD than the Single Life Table (using the Recalculate Annually Method). For example, assuming a growth rate of 8 percent on a $1 million inherited IRA, after 15 years a 72-year-old spouse who starts receiving Required Minimum Distribution immediately following her husband's death will have a total of $2,027,455 left in the IRA plus the total of RMDs received, but will have $2,400,081 if she rolls into a new IRA.[18] There is also an advantage for any successor beneficiaries (typically the surviving spouse's children). Because the IRA is a new IRA and not an inherited IRA, the children or other beneficiaries are the beneficiary of the IRA (and the RMD would be based on the oldest life using the Single Life Table and using the Reduce by 1

[16] Treas Reg § 1.408-8, Q&A A-5.
[17] IRC §§ 402(c)(9), 408(d)(3)(C)(ii)(II).
[18] Robert S. Keebler et al., *The Big IRA Book* 24 (Version 101 2009).

Method) instead of being treated as the successor beneficiary (for which the RMD would be based on the surviving spouse's life).[19]

4.3 **Sole-Beneficiary Requirement.** As previously mentioned, certain preferable tax treatments for a surviving spouse are only available if the surviving spouse is the sole primary beneficiary. Thus, it is fine to have the designation read "To my wife, Sally, if she survives me, otherwise equally to my children, Jack and Jill." But if the designation were "equally to Sally, Jack, and Jill," Sally would not be the sole primary beneficiary, and thus the designation would be treated as a distribution under the Individual RMD Rule.[20]

5. RMD for Persons Other Than a Spouse ("Individual RMD Rule").

5.1 **Minimum Distribution Requirements.** There are special RMD rules for individuals other than the surviving spouse who are beneficiaries of a retirement plan (other than a Roth IRA). In general, if a person (a living, breathing person) other than a spouse is designated as the beneficiary of a retirement plan, the Required Minimum Distribution must commence by December 31 of the year following the participant's death. If the participant had reached age 70½ before dying, however, the RMD is based on the life expectancy of the younger of the participant or the beneficiary.[21] The payout to the beneficiary will be based on the Uniform Lifetime Table using the Reduce by 1 Method.

[19] The correct life expectancy to pay out stretch payments to multiple beneficiaries is discussed in Section 5.2.
[20] See Section 5.
[21] Treas Reg § 1.401(a)(9)-5, Q&A A-5.

Following the death of the beneficiary, successor individual beneficiaries must commence the Required Minimum Distribution on December 31 of the year following the death of the beneficiary. The life expectancy will be based on the life expectancy of the beneficiary (not the successor beneficiary). The RMD will be based on the Single Life Table using the Reduce by 1 Method.

5.2 **Multiple Designated Persons.** If there are multiple designated beneficiaries (i.e., all are natural persons), distributions to each beneficiary still must commence by December 31 of the year following the participant's death. If the surviving spouse and another person or persons are named as a current beneficiary (and thus the surviving spouse is not the sole beneficiary), the Individual RMD Rule would also apply. The RMD payout period for multiple individual beneficiaries is based on age of the oldest beneficiary.[22] If the beneficiaries are Jack and Jill, and Jack is 15 years older than Jill, the Required Minimum Distribution will be based on Jack's shorter life expectancy, which means that Jill will lose the benefit of having the IRA payments paid to her over her longer actuarial life.

6. RMD for Nonpersons ("Default RMD Rule").

The Required Minimum Distribution for someone who is not a living person is generally five years after the death of the participant. A nonperson (which is treated as not being a Designated Beneficiary) includes an estate, charity, and most trusts. If a trust meets certain requirements, it will not be treated as a nonperson. The primary requirement for a trust not to be classified as a

[22] Treas Reg § 1.401(a)(9)-5, Q&A A-7.

nonperson is that the trust's beneficiaries all must be living persons. Such a trust, referred to as either an Accumulation Trust or a Conduit Trust, for RMD purposes looks through the trust to its beneficiaries and follows the previously described Spouse RMD Rule, the Individual RMD Rule, or the Default RMD Rule.[23]

If the Default RMD Rule applies, no distributions are required until five years following the participant's death.[24] But the entire amount of funds in the retirement plan must be distributed, and tax paid on it, within the five-year period. There is another rule if the participant died after reaching age 70½ and the RMD for the participant has commenced. In that case, the RMD for the beneficiary is based on the participant's life and the Single Life Table using the Reduce by 1 Method.

7. RMD for a ROTH IRA.

The RMD rules discussed above apply to qualified retirement plans, including IRAs, but not to Roth IRAs. The rules for a Roth IRA are very similar, but are not the same. A summary of the Roth IRA RMD rules can be found at the end of this article.

In a Roth IRA, there is no deduction for funds paid into the IRA, but a Roth IRA has tax-free buildup within the plan and there is no Required Minimum Distribution obligation for the participant while the participant is alive.[25] If a surviving spouse is the sole beneficiary of the Roth IRA and rolls it over into a new Roth IRA, she can treat it as her own Roth IRA and she, as was

[23] See Section 8 generally. "Accumulation Trust" is defined in Section 8.2 and "Conduit Trust" is defined in Section 8.3.
[24] Treas Reg § 1.401(a)(9)-3, Q&A A-2.
[25] IRC § 408A(c)(5).

the case with her deceased husband, will have no RMD obligation while she is alive. Other than that, the rules are the same for those who inherit any other retirement plan except that they follow the rules for a participant who died before his required beginning date of age 70½.[26] Thus, the Spouse RMD Rule requires distributions to begin when the participant would have been age 70½, the Individual RMD Rule requires distributions to begin by December 31 of the year following the participant's death, and the Default RMD Rule requires distribution of the entire account to be made within five years of the participant's death.

8. RMD for a Trust.

8.1 **General.** For RMD purposes, a trust is generally treated as a nonperson and thus will be required to follow the Default RMD Rule. If a trust is treated as either an Accumulation Trust or a Conduit Trust, which basically means that all the trust's beneficiaries are persons, then for RMD purposes the trust is ignored and the rules look through the trust to its beneficiaries. If the surviving spouse is the sole beneficiary of a Conduit Trust, but not an Accumulation Trust, then the surviving spouse Required Minimum Distribution rules will apply (without the option of rolling over the retirement plan benefits to a new IRA). Likewise, if the sole trust beneficiaries are one or more natural persons (which might include the surviving spouse if at least one more person is a beneficiary), the Individual RMD Rule will apply. Complex rules control whether potential contingent, successor,

[26] Treas Reg § 1.408-6.

remainder, and power-of-appointment beneficiaries should be counted for purposes of these rules.[27]

8.2 **Accumulation Trust.** An Accumulation Trust is a trust that meets certain requirements. The essence of the requirements is that the trust's beneficiaries are only living, breathing persons (or what are referred to as a Designated Beneficiaries). In many instances a Will or a trust will create numerous subtrusts or resulting trusts for various purposes and beneficiaries. Each of those separately created subtrusts or resulting trusts is considered to be a separate trust for these purposes—provided, of course, that each specific subtrust is adequately described in the designation.[28] The four requirements for an Accumulation Trust are as follows:

8.2.1 The trust is valid under state law.

8.2.2 The trust is irrevocable upon the death of the participant.

8.2.3 The trust's beneficiaries are identifiable individuals (i.e., they must be Designated Beneficiaries). In other words, the trust's beneficiaries must meet the Designated Beneficiary requirement. For an Accumulation Trust, potential contingent, successor, remainder, and power-of-appointment beneficiaries will often be considered in determining i) whether the trust has a nonperson as a beneficiary, and ii) the age of the oldest beneficiary. If a nonperson is a

[27] See Section 10.5.
[28] Treas Reg § 1.401(a)(9)-4, Q&A A-5(d).

potential beneficiary, in general, it will mean that the trust cannot be classified as an Accumulation Trust.

8.2.4 The trust agreement and certain other information is provided to the plan administrator.[29]

8.3 **Conduit Trust.** A Conduit Trust is an Accumulation Trust that requires that all the RMD received by the trust and any other distribution from the retirement plan be distributed to the trust's beneficiaries. A Conduit Trust thus must be valid under local law and irrevocable, all the beneficiaries must be identifiable individuals, and copies of various trust documents must be provided to the plan administrator.[30] In addition, all retirement plan distributions received by the trust must be distributed each year to the trust's beneficiaries.

The good news for a Conduit Trust is that the rules for determining whether the trust has Designated Beneficiary status are much easier to meet than for an Accumulation Trust. Only the current beneficiaries are counted, and potential contingent, remainder, successor, and power-of-appointment beneficiaries are ignored. But there is a cost. Because the trust must distribute all its Required Minimum Distribution and any additional plan withdrawals to trust beneficiaries, the trustee cannot withhold distributions to protect incompetent, spendthrift, or other beneficiaries who require greater financial protections. Neither can it pass on the principal of the retirement plan to remainder beneficiaries to the extent that the RMD rules require principal distributions to the current beneficiaries. The IRS has not

[29] Treas Reg § 1.401(a)(9)-4, Q&A A-5.
[30] Treas Reg § 1.401(a)(9)-5, Q&A A-7(c)(3), Ex. 2.

proscribed language to use in an Accumulation Trust so that it will qualify for Conduit Trust status.[31]

9. Pros and Cons to Designating Accumulation Trust Versus Conduit Trust.

9.1 **General.** There is only one technical difference between an Accumulation Trust and a Conduit Trust. In a Conduit Trust, all the RMD and any additional plan distributions received by the trust must be distributed to the trust's beneficiaries annually. But that one difference creates quite a number of tax and nontax issues that must be considered when drafting a trust that will be the beneficiary of retirement funds. In most situations, a Conduit Trust has no particular advantages over an Accumulation Trust except that potential beneficiaries (such as contingent, remainder, successor and power-of-appointment beneficiaries) cannot be nonpersons and should ideally be younger than the primary beneficiary. If a trust is established for a surviving spouse, the trust can use the Recalculate Annually Method

[31] The following Conduit Trust provision was partially inspired by Priv Ltr Rul 200607031. Included is a provision for marital trusts that have made a QTIP election, requiring all accounting income to be distributed annually. "Notwithstanding anything to the contrary and in addition to any dispositive provisions of any trust created under this [Will / Agreement], with regard to any qualified retirement plan that is payable to any trust created under this [Will / Agreement], beginning in the year following [my death / the death of a Trustor who was the participant in the qualified retirement plan] and each year thereafter, Trustee shall withdraw from such qualified retirement plan (a) the required minimum distribution as defined under Code Section 401(a)(9) and the proposed and final regulations promulgated thereunder, (b) so much of net income and corpus for the benefit of the beneficiary as the Trustee determines to be necessary for the beneficiary's health, education, maintenance, or support, and (c) if the trust has elected to qualify under Code Section 2056(b)(7), such additional amount, if any, equal to the income of the retirement plan for the year less amounts withdrawn under (a) and (b). Notwithstanding anything to the contrary, any and all amounts withdrawn from any qualified retirement plan payable to the trust (net of expenses properly charged thereto) must be distributed to the beneficiary or beneficiaries of the trust, not less frequently than annually, free of trust. The intent of this section is that to the extent necessary to qualify any trust under this [Will / Agreement] as a designated beneficiary under Code Section 401(a)(9) and the proposed and final regulations promulgated thereunder, any trust receiving a required minimum distribution from a qualified retirement plan will be considered a conduit trust. For purposes of this [Will / Agreement], the term "qualified retirement plan" includes, without limitation, a qualified pension plan, profit sharing plan, 401(k), Keogh, individual retirement account (including a SEP, deductible, nondeductible, Education, or Roth IRA), or any other retirement plan subject to the required minimum distribution rules under Code Section 401(a)(9)."

which will stretch benefits. If the deceased participant died before reaching 70½, RMD of a Conduit trust will be deferred until that date which is not the case if the surviving spouse if the beneficiary of an Accumulation Trust.

9.2 **Stretch.** One benefit of a Conduit Trust is that it will normally stretch the distributions for a surviving spouse. If after the death of the surviving spouse, it might pass to parents, grandparents, or aunts and uncles. If an Accumulation Trust was used, the oldest of the named potential beneficiaries will be the life used under the Single Life Table. If the trust is an Accumulation Trust and the primary beneficiary is the surviving spouse, the Required Minimum Distribution would require that the funds be distributed based on her life (using the Individual RMD Rule). Half of the surviving spouses will live longer than this life and will thus outlive their benefits and those benefits must start right after the death of the participant. Even if the primary beneficiary is a child or children, the oldest Designated Beneficiary might be the child's aunt who is 20 or 30 years older than the child. On the other hand, if the trust is a Conduit Trust, the RMD would be based on just the child's life expectancy. In either situation, the Single Life Table would be applied. If the Accumulation Trust's primary beneficiary is the surviving spouse (typically with the remainder to the children), distributions must commence immediate after the death of the participant using the Individual RMD Rule.

9.3 **Income Distributions.** One of the disadvantages of a Conduit Trust is that all the retirement plan benefits, including RMD received by the trust, must be distributed to the trust's beneficiaries. Because one of

the primary purposes of a trust is to manage both principal and income for persons who cannot manage their affairs, or to protect remainder beneficiaries (such as children from a prior marriage who receive assets only after the death of a stepparent), this can be quite problematic. If a spouse from a second marriage has funds that are adequate for her needs, the trust might have been established to provide for her only if she ran through all her other assets. But that would not be possible with a Conduit Trust, which requires all plan distributions, but not other income, be distributed to the surviving spouse. A Conduit Trust probably does not make sense for a special-needs beneficiary—someone who is handicapped—as any distribution will generally reduce governmental support payments.

If a Conduit Trust is needed because of problems with potential successor beneficiaries, a Conduit Trust might be workable. The RMD for a five-year-old is only 1.28 percent of the value of the trust. For a 25-year-old, it is only 1.71 percent of the value of the trust. If the trust had $100,000, the distributions would be between $1,280 and $1,710. Of course, the larger the trust funds, the more likely that the distributions would be more than the child could handle.

The ability of an Accumulation Trust to not distribute but to reinvest income in many situations can be a valuable asset that is not available with a Conduit Trust.

9.4 **Tax Rates.** Federal income tax rates are generally higher for a trust than a beneficiary would pay on the same income. A trust hits its highest tax rate of 35 percent at only $11,650 of taxable income. A

single individual or a married couple filing jointly currently does not reach the 35 percent tax rate until their taxable income has reached $388,350. The Accumulation Trust that in fact accumulated its income, and did not distribute it to trust beneficiaries, will generally pay more tax on its income than would the trust beneficiaries if that income had been distributed to them.

9.5 **Better Planning.** If a Conduit Trust is used, it is easy to provide for normal contingencies, such as providing for where the funds go following the death of the primary beneficiary. Only the primary beneficiaries are considered in determining whether the trust meets Designated Beneficiary status and who is the oldest measuring life. Potential contingent, remainder, successor, and power-of-appointment beneficiaries are ignored. But this is not the case for an Accumulation Trust. If an Accumulation Trust is used, these beneficiaries must be considered.

10. What Is a Designated Beneficiary, and Why Is It So Important?

10.1 **Designated Beneficiary.** A Designated Beneficiary is not what it would seem. It is not the person or entity designated by the participant to receive plan benefits at death. It is a status of a participant designating only living, breathing human beings as the retirement plan's beneficiary. A plan designation will be to a Designated Beneficiary only if all the persons designated are natural persons. The Internal Revenue Code defines a Designated Beneficiary as "any individual designated as a beneficiary by the

employee."[32] The determination of who is a Designated Beneficiary "will be * * * based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year" of the year after the participant's death.[33] So a designation to Jack and Jill is a Designated Beneficiary. A designation to a class of persons such as "my children" is also a Designated Beneficiary.[34] If an older beneficiary could be added to the class of beneficiaries, as might be the case with a power of appointment used in a trust in which the ages of the beneficiaries are not identifiable, there is no Designated Beneficiary.[35]

10.2 **Spouse as Sole Beneficiary.** If the surviving spouse is the sole primary beneficiary,[36] potential contingent, remainder, successor, or power-of-appointment beneficiaries are ignored when determining whether Designated Beneficiary status has been achieved. This rule applies to a Conduit Trust in which the surviving spouse is the sole current beneficiary, but unfortunately not to an Accumulation Trust.[37] If Harry designated Sally as his primary beneficiary, and then designated his mother, Gertrude, who is older than Sally, as his alternative beneficiary, Sally would be the sole Designated Beneficiary. Gertrude would not be treated as a Designated Beneficiary for any purpose—unless, of course, Sally predeceased Harry.

[32] IRC § 401(a)(9)(E).
[33] Treas Reg § 1.401(a)(9)-4, Q&A A-4(a).
[34] Treas Reg § 1.401(a)(9)-4, Q&A A-1.
[35] Treas Reg § 1.401(a)(9)-4, Q&A A-4.
[36] See discussion at Section 4.3.
[37] Treas Reg § 1.401(a)(9)-5, Q&A A-7(c)(3), Ex. 1.

10.3 **Primary Types of Nonperson Beneficiaries.** A nonperson can never be considered to be a Designated Beneficiary. The primary types of nonperson beneficiaries are charities, most trusts, estates, and (in some situations) an agreement to pay estate taxes. Often, designating any of these entities, even as a potential beneficiary, will cause the designation to not have Designated Beneficiary status. If a nonperson is designated as a beneficiary, the Default RMD Rule will apply. The Default RMD Rule treatment can be avoided in various ways, including designating the spouse as the sole current beneficiary,[38] establishing a separate account postdeath for individuals,[39] or having the nonperson paid off[40] or disclaim[41] its interest before September 30 of the year following the participant's death.

10.3.1 **Charity.** A designation to a charity, even if contingent, will not be a Designated Beneficiary.[42] So a designation to "Jack, Jill, and Church" will not be a Designated Beneficiary. A designation to "Jack, but if Jack predeceases, to Church" will also not be a Designated Beneficiary. Any contingent or residual beneficiary is considered in determining whether a designation is a Designated Beneficiary. It does not matter one bit that Jack is alive, healthy as an ox, and the retirement funds will never go to the Church. It makes no sense, but that is the rule. Note that potential contingent, remainder, successor, or power-of-

[38] See Section 10.2.
[39] See Section 10.4.1.
[40] See Section 10.4.4.
[41] See Section 10.4.3.
[42] Treas Reg § 1.401(a)(9)-5, Q&A A-7(b).

appointment beneficiaries are not considered if a designation is to a Conduit Trust or to a surviving spouse who is the sole beneficiary.

10.3.2 **Trusts.** Generally, trusts are not Designated Beneficiaries.[43] As previously discussed, there are two exceptions: Accumulation Trusts[44] and Conduit Trusts.[45] As a general matter, in an Accumulation Trust all potential beneficiaries, whether contingent, successor, residual, or under a power of appointment, are considered. If a current beneficiary is a nonperson, the trust will be considered not to have a Designated Beneficiary and therefore cannot be either an Accumulation Trust or a Conduit Trust. In a Conduit Trust, only the current trust beneficiary must be a person, and potential beneficiaries who are contingent, successor, residual, or under a power of appointment are ignored.

10.3.3 **Estate or Estate Expenses.** Any designation to distribute retirement funds to "my estate" or similar will not be a Designated Beneficiary.[46] Likewise, a designation to pay estate expenses will not be a Designated Beneficiary. For example, a designation to pay the fund's share of estate administration expenses will not be treated as a Designated Beneficiary.

[43] See generally Ltr Rul 201021038, which shows the many traps of naming a typical revocable trust as the beneficiary of an IRA.
[44] See Section 8.2.
[45] Section 8.3.
[46] Treas Reg § 1.401(a)(9)-4, Q&A A-3; Priv Ltr Rul 200650022; Priv Ltr Rul 200846028.

10.3.4 **Estate Taxes.** An agreement to pay estate taxes that would otherwise be payable from the plan or IRA assets will generally not cause the designation to lose its Designated Beneficiary status.[47] This is because the assets in an IRA or plan are already subject to a charge to pay their proportionate share of estate taxes. Note that if the retirement funds are payable to a surviving spouse, no estate taxes are due from the bequest because of the exemption of assets passing to a surviving spouse,[48] and thus no estate taxes could otherwise be charged against such a payment. The use of retirement benefits to pay estate taxes causes the distribution to be taxable. Thus, estate taxes should not be paid from retirement funds if other assets are available.

10.3.5 **No Designation by Participant.** If the participant dies and failed to complete a designation, or the designation cannot be found, it may still be treated as if there is a Designated Beneficiary. If no beneficiary is designated, but the plan provides that the distribution is made to described individuals (e.g., surviving spouse or children), then there will be a Designated Beneficiary.[49] Unfortunately, most plan and IRA agreements make the default distribution to the participant's estate, which would not be a Designated Beneficiary.

[47] See Natalie Choate, *Life and Death Planning for Retirement Benefits* § 6.2.10 (7th ed 2011).
[48] IRC § 2056.
[49] Treas Reg § 1.401(a)(9)-4, Q&A A-2.

10.4 **Postdeath Events.** Following the death of the participant, it may be possible to affect whether a designation has a Designated Beneficiary and who is the oldest life if there are multiple individual beneficiaries.

10.4.1 **Separate Account Established.** Perhaps the best way to not have to deal with multiple lives or with beneficiaries who are nonpersons is to establish a separate IRA for each beneficiary. Doing so means that the sole beneficiary of each separate account is the actuarial life used for determining distributions. Further, if the separate account is established by December 31 of the year following the death of the participant, it can cure certain Designated Beneficiary problems. For example, if Harry gave 50 percent of his IRA to Jack and Jill and 50 percent to the church, each could establish a separate account on or before September 30 of the year following the participant's death. Further, Jack's IRA will not consider Jill's life in determining the RMD for Jack's IRA, and Jill's IRA will not consider Jack's life in determining the Required Minimum Distribution for Jill's IRA.[50] The fact that the church was a nonperson would mean only that its share of the IRA funds will need to be distributed to it based on the Default RMD Rule.

10.4.2 **Separate Accounts and Trusts and Estates.** Establishing a separate account can also help certain trust and estate designation problems. If the retirement plan designation makes a trust or an estate a plan beneficiary, and the

[50] Treas Reg § 1.401(a)(9)-8, Q&A A-2(a)(2).

provisions of the trust, Will, or intestate succession divide the plan benefits to a number of different beneficiaries, there can be postdeath separate IRAs established for each beneficiary. Each will be treated for all purposes as a separate IRA, *except* that the separate account will have no effect on the Designated Beneficiary status or on the determination of who is the oldest life for RMD purposes.[51] Thus, if Harry designates that his IRA is to be payable on his death to his revocable trust, and that trust distributes half of Harry's assets to Jack in a Jack Trust and half to Jill in a Jill Trust, sub-IRAs can be created for each trust. But the applicable life to determine RMD for both the Jack Trust and the Jill Trust will be Jack's life, because he is older than Jill.

But the opposite holds true if timely separate accounts are established and if the designation actually designates each trust (whether established by a Will, revocable trust, or otherwise), such as a designation of "50 percent to the Jack Trust and 50 percent to the Jill Trust."[52] Thus, for example, if the Jack Trust and the Jill Trust are Conduit Trusts and Jack and Jill are the sole current beneficiaries of their respective trusts, the Required Minimum Distribution for the Jack Trust would be based on Jack's life expectancy and the RMD for the Jill Trust would be based on Jill's life

[51] Treas Reg § 1.401(a)(9)-4, Q&A A-5(c); Priv Ltr Rul 200317041; Priv Ltr Rul 200317043.
[52] Priv Ltr Rul 200537044.

expectancy. If a trust that was called a Descendants Trust was created or in existence for each child or grandchild under age 25, then the designation should be to the Descendants Trust created for each beneficiary.[53]

10.4.3 **Disclaimer.** A disclaimer of retirement benefits can mean that the person who disclaimed the interest will not be treated as a beneficiary. If the remaining or successor beneficiaries are natural persons, then the retirement plan will be distributed as if it had a Designated Beneficiary (such as a spouse, a person, or multiple persons).[54] A disclaimer by a nonperson will not, however, cure a designation problem which arose because a beneficiary is a nonperson. For example, if Sally disclaims her interest in an IRA following Harry's death, the assets might pass to Jill. Jill's life will be the actuarial life used to determine the RMD and Sally's life will not be used. Two requirements must be met. The first requirement is that the disclaimer must be a qualified disclaimer.[55] For a qualified disclaimer, Sally cannot have received any benefits from the retirement funds before her disclaimer was made and can have no right to direct to whom the disclaimed assets will pass.[56] The

[53] For example: "All benefits payable under the plan or account as a result of my death are to be divided into shares with one share for each child of mine who survives me and with a share by right of representation for any child of mine who does not survive me, but leaves issue surviving me. Any share established for a beneficiary over age 25 is to be transferred to the trustee of the separate Descendants Trust for each such beneficiary created at my death in the _____ Revocable Trust dated _____."
[54] Treas Reg § 1.401(a)(9)-4, Q&A A-4(a).
[55] IRC § 2518.
[56] The IRS has allowed a disclaimer even though the beneficiary received a mandatory RMD in the year of death. Rev. Rul. 2005-36; 2005-26 IRB 1368.

second requirement is that the disclaimer must be completed no later than September 30 of the year following Harry's death. September 30 of the year following Harry's death is probably long past the nine-month deadline for completing disclaimers. The normal nine-month disclaimer deadline would typically apply, but the September 30 deadline might apply if the potential disclaimant was not yet 21 years because such a potential disclaimant can wait until his or her 21st birthday to complete a disclaimer.

10.4.4 **Postdeath Payoff.** If a beneficiary is paid his portion of the retirement benefits in full on or before September 30 of the year following the participant's death, the beneficiary will not be treated as the oldest person for purposes of determining the RMD.[57] As is the case with a disclaimer, paying off the beneficiary on or before September 30 of the year following the participant's death will not cure a Designated Beneficiary problem if that designee was not a natural person.

10.4.5 **Postdeath Trust Modification.** Following the death of the participant, a review of the documents might reveal that the designations to a trust did not meet all the technical rules. One approach that has been attempted to fix a trust is to ask a court to reform the trust's provisions so that the distribution can be stretched. Alas, this approach has not

[57] Treas Reg § 1.401(a)(9)-4, Q&A A-4(a).

been successful before the Tax Court.[58] Taxpayers have had mixed results requesting rulings from the IRS, with one loss[59] and a one win.[60] In the one private letter ruling win for taxpayers, there was an independent trustee who was expressly given authority to modify the trust so that it would be considered to be a Designated Beneficiary. The postdeath amendments were made and the ruling held that this particular trust was a Conduit Trust. The general reaction, however, has been that the facts that were in existence on the date of death of the participant control and that the only postdeath modifications that will be countenanced are those already approved by Congress.[61]

10.4.6 **Birth or Death of a Beneficiary Following Participant's Death.** The death of a beneficiary after the death of the participant, but before September 30 of the year following the participant's death, will generally not remove that person as a beneficiary for purposes of determining who is the oldest beneficiary. But if the beneficiary disclaimed the interest after the participant's death, but before his or her own death, the beneficiary would not be considered a beneficiary for purposes of determining the oldest

[58] *Estate of La Meres v. C.L.R.*, 98 TC 294 (1992).
[59] Priv Ltr Rul 201021038.
[60] Priv Ltr Rul 200607031.
[61] For example, IRC § 2055(e)(3).

beneficiary.[62] The birth of a new beneficiary after the date of death of the participant will for all purposes be ignored.

10.5 **Contingent, Remainder, Successor, and Power-of-Appointment Beneficiaries.** In general, contingent, remainder, successor, and power-of-appointment beneficiaries are considered in determining whether there is a Designated Beneficiary and who is the oldest life for purposes of determining the Required Minimum Distribution.

10.5.1 **Contingent, Remainder, and Successor Beneficiaries.** Potential contingent, remainder, and successor beneficiaries are considered in determining the Designated Beneficiary status of the trust and the age of the oldest beneficiary. For an Accumulation Trust, potential beneficiaries are generally included in determining whether the trust has Designated Beneficiary status (i.e., all the potential beneficiaries are individuals). If a person "has any right (including a contingent right) to a participant's benefit beyond being a mere potential successor," then that person's age will be included in determining the RMD for the trust.[63] Who is a "mere potential successor" is "not entirely clear."[64] It is therefore prudent to simply not name a potential beneficiary unless that beneficiary's life is expected to be counted in determining the trust's RMD. The determination of who are potential beneficiaries is generally applied to contingent beneficiaries regardless of the likelihood of whether the

[62] Treas Reg § 1.401(a)(9)-4, Q&A A-4(c).
[63] Treas Reg § 1.401(a)(9)-5, Q&A A-7(c).
[64] Richard L. Fox, *Charitable Giving: Taxation, Planning, and Strategies* ¶ 22.06[1][e][iii] (2d ed 2011).

contingency will occur. A contingent beneficiary is counted as potential beneficiary if the contingent beneficiary will take only upon the death of the primary beneficiary.[65] An important exception to this rule is that if the surviving spouse or a Conduit Trust is the current beneficiary, potential contingent, remainder, and successor beneficiaries are ignored.

10.5.2 **Power-of-Appointment Beneficiaries.** A power of appointment is a commonly used drafting device in a trust. For example, Harry may create a trust for Sally that provides that she is entitled to income for life, and that she has the power at her death to appoint the remaining assets outright or in trust to her issue or a charity. If she does not make an appointment, then the assets pass equally to Harry's children, Jack and Jill. In this situation, it is clear that Sally could appoint the trust assets to a charity at her death. Thus, the Power of Appointment would cause this trust to not qualify as an Accumulation Trust. The basic rule for an Accumulation Trust is that all the potential appointees under a power of appointment must qualify as identifiable individuals. Further, any possible appointees are considered in picking the oldest life.[66] So if a power of appointment is used, it is common to limit the power of appointment only to persons (the breathing kind) younger than the primary beneficiary. It is common to include a general power of

[65] Priv Ltr Ruls 200438044; 200228025.
[66] Treas Reg § 1.401(a)(9)-4, Q&A A-1.

appointment in a trust so that it is not subject to the Generation Skipping Transfer Tax. If so, the trust could not be an Accumulation Trust. It would need to be a Conduit Trust. If the trust is a Conduit Trust, potential appointees under a power of appointment are ignored. Thus, the trust could be a Conduit Trust and its sole Designated Beneficiary would be Sally with a potential appointment to a charity or anyone else after Sally's death. The Required Minimum Distribution for Sally would be determined under the Spouse RMD Rule (without a rollover IRA).[67]

11. Example 1: Children From Second Marriage (or Spouse Is a Spendthrift).

There are many, many different problems that families may face when planning for the disposition of retirement plan assets. The following sections illustrate some common problems and potential planning techniques to resolve them.

Harry and Sally are married. Harry has two children, Jack and Jill, from his first marriage. Harry wants to provide for Sally at his death, but wants any extra funds not spent during Sally's lifetime to pass to his children. He is concerned that if he makes Sally the beneficiary of his $1 million in retirement benefits, Sally will not pass them on to Jack and Jill following her death. Harry and Sally are unlikely to have to pay estate taxes on either estate.

[67] See Section 4.1.

This is a familiar problem. A similar problem occurs if Sally cannot handle money because she is a spendthrift (too many trips to Paris) or she is medically incapacitated.

The first issue Harry faces is that Sally has a right to receive the retirement funds unless she consents otherwise. The Retirement Equity Act provides that for some retirement plans, but not IRAs, the surviving spouse has a right to receive the plan benefits following the death of the participant.[68] Sally cannot have waived her rights in a retirement plan in a prenuptial agreement.

If Harry's separate assets and other retirement benefits that Sally is entitled to are enough for Sally to live on, Harry (with Sally's consent if required) might want to put his other assets in trust. He can name Jack and Jill outright (not in trust) as the beneficiary of the retirement plans. They would be subject to the Individual RMD Rule based on the oldest life of Jack (because he is older than Jill). Or Jack and Jill can each establish their own separate IRAs following Harry's death, and then each life would control the RMD for each separate IRA. By not giving Sally the IRA, Harry ensures that the distributions are stretched over Jack's life expectancy, or Jack and Jill's separate life expectancies, rather than over Sally's much shorter life.

Assuming that there are not enough other assets to provide for Sally, Harry should probably name a trust as the IRA's designated beneficiary that provides for Sally during her lifetime. On Sally's death, the remaining trust assets, including the IRA, would pass to Jack and Jill. If the trust was not an Accumulation Trust or a Conduit Trust, the Default RMD Rule would apply (which generally requires that the entire benefit be paid out within five years

[68] IRC §§ 401(a)(11), 417.

of Harry's death). An Accumulation Trust might be a good choice. That would allow Sally's life, as the oldest of Sally, Jack, and Jill, to be the measuring life for the payout. The payout would commence immediately (without deferral to when Harry would have reached age 70½ and would be based on the Individual RMD Rule. The RMD received each year could be reinvested in the trust to the extent that Sally did not need it for her support. If Harry wanted to name his church as either a current or contingent beneficiary of the trust, the Default RMD Rule would apply, since the trust would not qualify as an Accumulation Trust. If the trust was a Conduit Trust, a potential contingent, residual, or successor nonperson beneficiary would not prevent the trust from having Designated Beneficiary status, since a Conduit Trust ignores potential beneficiaries. If the trust was a Conduit Trust, however, each year the Required Minimum Distribution would need to be distributed to Sally. A Conduit Trust under which Sally was the sole current beneficiary would use Sally's life as the measuring life and pay out the benefits to her based on the Spouse RMD Rule using the Recalculate Annually Method. Thus, if Sally lived to a ripe old age, most of the retirement funds would be distributed to her even though it might turn out that she did not need the funds for her support.

12. Example 2: Trust for Child With Special Needs.

Harry has $800,000 in his IRA. Harry and Sally have two children, Jack and Jill. As the result of an early childhood mishap involving his head that occurred while fetching a pail of water, Jack is developmentally disabled and will never be able to take care of himself. It is likely that when Harry and Sally are unable to take care of Jack, he will have to go into an institution for care and will primarily rely on state support for his care.

Harry and Sally want to benefit both Jack and Jill, and want to make sure that any benefit to Jack is not offset by a commensurate reduction in his state support.

The primary beneficiary of Harry's IRA should, of course, be Sally. If Harry dies first, this will allow Sally to roll over the IRA into a new IRA. The advantage to Sally is that the RMD will now be based on the Uniform Lifetime Table and would not need to commence until Sally reaches age 70½. The RMD under the Uniform Life Table is much lower than the RMD under the Single Life Table, which would have been the case if Sally had not rolled over the IRA after Harry's death.

The contingent beneficiary of the IRA, if Sally does not survive Harry, might be 50 percent for Jill and 50 percent for a trust for Jack's benefit. Following Sally's death, the IRA can be divided into two separate accounts: one for Jill and one for the trust for Jack's benefit. This means that Jill can be the sole beneficiary of her IRA and the payout would be based on her life using the Single Life Table and the Reduce by 1 Method. If two separate IRAs were not established, the IRA might not have Designated Beneficiary status (unless the trust was either an Accumulation Trust or a Conduit Trust), in which case the Required Minimum Distribution would be based on the Default RMD Rule, which usually requires the IRA to be fully paid to the beneficiary within five years of Sally's death.

Harry and Sally would like the trust for Jack to be either an Accumulation Trust or a Conduit Trust so that the Default RMD Rule will not apply to it. If it is a Conduit Trust, all the RMD must be distributed to Jack each year. But since Jack has special needs and will probably be taken care of by the

state, the use of a Conduit Trust probably does not make sense. The payments from the trust will only reduce the support that the state provides to Jack. An Accumulation Trust might work because it would allow the trustee to make payments only for Jack's needs that are not being provided for with state support. But note that if the trust provides that on Jack's death the funds go to Jack's grandfather, the RMD would be based on Jack's grandfather's age and not Jack's age. This would mean that the RMD would be much larger each year because it would be based on Jack's grandfather's age. Also note that if the trust provides that the assets in the trust pass to a charity at Jack's death, the trust will not qualify as an Accumulation Trust and the Default RMD Rule would apply.

13. Example 3: Trust for Minor Children or Those Who Can't or Shouldn't Handle Money.

Harry has an IRA with $400,000. He is a widower. His daughter Jill is only 15 years old. How should he handle the IRA for her benefit?

What is the best solution for a distribution to a minor child? Harry should provide that the primary beneficiary of his IRA is a trust for Jill's benefit. The trust for Jill can easily be a Conduit Trust. The RMD period under the Single Life Table for a 15-year-old is 67.9 years, which would be only 1.47 percent of the balance in the account. If the trust terminated when Jill was 25, the Required Minimum Distribution would still be only 1.72 percent (1/(67.9 – 10)) of the balance in the IRA. If the IRA after ten years had a balance of $460,000, the trustee would be required to distribute to Jill only around $7,917 a year—easily absorbed by school supplies, clothes, medical care, and music downloads for Jill.

But what if Jill was 40 and a big spender? What if she had a judgment creditor and Harry was worried that her husband might divorce her for any part of her inheritance that he could get away with? Harry might think that Jill should not get her inheritance until age 60. At age 45, the RMD start out at 2.58 percent of the balance in the IRA, and at age 60 it is 3.97 percent of the balance in the IRA. Is this too much for a $450,000 account? What if the IRA had $2 million in it? As the account balance increases and the beneficiary ages, it makes less and less sense to use a Conduit Trust. If an Accumulation Trust is to be used, Harry needs to be cautioned that he cannot name a nonperson as a potential beneficiary. He should also be cautioned as to the consequences of naming someone older than Jill as a potential beneficiary, since the RMD will be based on that person's age and not Jill's younger age.

14. Example 4: Strategies to Minimize Estate Taxes.

Harry and Sally have a $13 million estate (Harry's estate is $7.12 million and Sally's estate is $5.88 million). As part of Harry's estate, he owns a $1 million IRA. The estate tax exemption is currently $5.12 million for an individual and $10.24 million for a married couple. How should Harry and Sally set up their estate at their death to minimize their estate taxes?

The time-honored approach generally utilized to reduce estate taxes at the first death of a married couple is to create a trust at the first death that is equal to the estate tax exemption (the "bypass share"). The assets in the trust are not taxed on the first death because of the exemption, and they are not taxed on the second death because the surviving spouse, although a beneficiary of the trust and possibly even the trustee, does not own the assets

for estate tax purposes. This type of trust is known as a bypass trust, credit shelter trust, or family trust. Generally, income and principal is paid to the surviving spouse only for her health, education, maintenance, and support. On the first death of Harry or Sally, a bypass trust equal to the $5.12 million exemption amount is indicated. If the size of the bypass trust increases from $5.12 to $7 million between the first and the second death, the entire $7 million in the trust is excluded from the estate of the survivor for estate tax purposes. The assets that are not part of the bypass share will generally pass to the surviving spouse (the "marital share") and are not taxed on the first death because of the marital deduction. The marital share can be transferred to the surviving spouse either outright or in a trust, provided that if it is in a trust, it must meet certain requirements, the primary one of which is that all the trust income must be distributed to the surviving spouse.

If Harry and Sally had a $30 million estate and were philanthropically inclined, the best approach for them would be to give the IRA to charity at Harry's death, avoiding both the income tax and the estate tax. If they had no desire to benefit a charity, they could transfer the IRA to their grandchildren, thereby stretching the distribution over the lives (oldest life or, if separate IRAs are established, the life of each) of their grandchildren,[69] rather than over Sally's life. Because the IRA has only $1 million, it would not trigger the generation-skipping tax because it is less than the $5.12 million exemption.

[69] Assuming an 8 percent growth rate on a $1 million IRA for a 50-year-old child who dies at age 84, the total funds in the IRA would be zero, but the total RMD received by the child would be $4,722,125. But if a grandchild was selected who was age 25 and the grandchild died at age 84, while the funds in the IRA would be zero, the total RMD received by the grandchild would be $18,278,651. Keebler et al., *supra*, at 24.

But Harry and Sally are not so rich that they are ready to give the retirement funds away at their first death to a charity or grandchildren. So Harry and Sally decide at their first death to fund a bypass trust equal to the exemption amount (which may change over time but is currently $5.12 million). Assuming that Harry dies first, the $5.12 million bypass share passes to the bypass trust, with the remaining $2 million marital share passing to Sally either outright or in trust. How should the $1 million IRA be designated? There are a number of choices. The most tax-efficient choice is an outright distribution to Sally. The next best choice is to give the retirement plan to a marital trust. The worst choice is to pass the IRA to the bypass trust. Each possible choice is discussed below.

14.1 **Outright Distribution to Sally.** From the point of view of tax efficiency, it would be best to give the IRA outright to Sally and not utilize a trust. She could then roll it over to a new IRA in which she is the participant and stretch the payments to her based on the Uniform Lifetime Table using the Recalculate Annually Method (rather than the Single Life Table and the Recalculate Annually Method, which would be the case if Sally only had an inherited IRA). Further, her children, Jack and Jill, could stretch what is left in the IRA after Sally's death using their life expectancies and not Sally's life, which would be the case if Sally had an inherited IRA. In either case, the RMD for Jack and Jill would be based on the Single Life Table, and if a spousal rollover was utilized, it would be based on the older of Jack

and Jill (or their separate life expectancies if they each established their own IRAs).[70]

14.2 **Bypass Trust.** An outright distribution of the IRA to Sally might not work if Jack and Jill are Harry's children from a prior marriage or if Sally is unable to handle her finances. If the bypass trust was a Conduit Trust, the Required Minimum Distribution would be based on the Spouse RMD Rule. The bypass trust is the worst choice to give the $1 million IRA to. As mentioned, the funds in the bypass trust escape estate taxes on Harry and Sally's second death. So Harry does not want to give the IRA to the bypass trust because a significant percentage of the funds distributed from the IRA to the trust will eventually be lost to income taxes as the funds are withdrawn. Further, the RMD rules applied to a Conduit Trust will guarantee that as Sally ages, the principal of this trust will be reduced and will be transferred to Sally and ultimately included in her taxable estate to the extent not consumed.

14.3 **Marital Accumulation Trust.** If Harry gave the $1 million IRA to an Accumulation Trust that allowed the trustee the full discretion as to whether income was accumulated or distributed, Sally can be protected from wasting money and Harry can be sure that at Sally's death, Jack and Jill receive their inheritance. But this type of trust does not qualify for the marital deduction for federal estate tax

[70] See Section 4.2.

purposes. To qualify, the trust must make a QTIP election and distribute all income following Harry's death to Sally.[71]

If the trust selected is an Accumulation Trust, the RMD will be based on the life of the oldest beneficiary of the trust. That would likely be Sally if the beneficiaries were Sally, Jack, and Jill. The Required Minimum Distribution will follow the Individual RMD Rule, and thus the RMD will commence on December 31 of the year following Harry's death and will use the Single Life Table and the Reduce by 1 Method.

If for some reason Harry insists that a beneficiary of the trust following Sally's death is a nonperson such as a charity or otherwise, the trust does not meet the requirements for an Accumulation Trust. Thus, the IRA must be distributed in full within five years of Harry's death, unless Harry was 70½ when he died. In that event, the RMD would be based on Harry's life expectancy if he was alive and using the Single Life Table and the Reduce by 1 Method. We need another plan!

14.4 **Marital Conduit Trust.** If the IRA must be made to Sally in trust to ensure that the funds in the trust will pass to Harry's children on Sally's death, one choice is for the IRA to pass to a marital trust that distributes all its income and that makes a QTIP election. It may make a QTIP election only if all the trust's income, including the income within the IRA, must be distributed to Sally at least annually.

[71] IRC § 2056(b)(7).

Note that the income on the $1 million IRA owned by the marital trust may be greater or lesser than the RMD.[72]

If the trust is a Conduit Trust and Sally is the sole current beneficiary, the Required Minimum Distribution will be based on Sally's life and will follow the Spouse RMD Rule. Thus, the benefits will commence when Harry would have reached age 70½ and will use the Single Life Table and the Recalculate Annually Method. Sally must be distributed the greater of the RMD or the trust's accounting income to meet both the QTIP election requirements and the RMD rules. A Conduit Trust is the best choice, if a gift in trust is required, to stretch out the payments to the surviving spouse, since they do not need to commence until she is age 70½. Although at some point the principal of the IRA will be distributed and consumed, other non-IRA assets of the trust might appreciate in value and partially or fully offset the principal reduction of the IRA plan.

14.5 **Pecuniary Gift of Retirement Plan Causes Gain.** The division of the assets between the bypass share and the marital share can create taxable income! An example might be helpful. Assume that Harry wants to pay his $100 debt with stock worth $100 whose basis is $10. Tax law provides that the satisfaction of an obligation with appreciated asset will be treated as a sale of the asset, thus generating taxable gain to Harry of $90.[73] Similarly, if the formula in the Will is such that there is a pecuniary or dollar bequest to the share that is

[72] Rev Rul 2006-26, 2006-1 CB 939, includes requirements for a QTIP trust deduction that includes retirement benefits. The surviving spouse must be able to require the income from plan assets to be distributed annually. Further, there can be no prohibition on the trustee from withdrawing an amount greater than the RMD from the plan.
[73] See generally Rev Rul 55-117, 1955-1 CB 233.

satisfied by distributing the retirement funds, funding the formula amount will be a taxable event. The way to avoid this problem is to use the IRA designation and not use a formula. It is generally preferable for the retirement plan designation to pass to a specific person or persons or a specific trust. If the estate is designated as the beneficiary, the retirement assets can pass as part of the residue without triggering gain (e.g., a formula amount to the bypass trust, with the residue to the marital share).

14.6 **Charitable Remainder Trust Alternative.** Another alternative is to transfer the IRA after the first death to a charitable remainder trust in which the surviving spouse (and possibly the children after her death) is the beneficiary of the trust for life. The trust can receive the entire IRA without any income tax liability because it is a tax-exempt entity. The trust can have a distribution stream equal to 5 percent of the assets each year as a unitrust. The benefit of this approach is that a full estate tax marital deduction is available if the surviving spouse (and not the children) is the sole noncharitable beneficiary. The tax-free buildup inside the charitable trust is maintained. On the other hand, this structure deprives the trustee of the power to vary distributions of trust assets if needed by the surviving spouse. And of course, after the surviving spouse's death, the assets end up in a charity instead of going to the children.[74] If the children are income beneficiaries of the charitable remainder trust, no marital deduction is available, but there would be a charitable deduction. In order to meet the requirement that the present value of the charitable gift be at least

[74] See Christopher Hoyt, *When a Charitable Trust Beats a Stretch IRA*, Tr & Est, May 2002; Christopher Hoyt, *Funding Bypass Trusts with Retirement Assets*, Prob & Prop, May/June 2004.

10 percent of the gift to the trust,[75] the surviving spouse and children need to be older so that the life term of the trust does not generate a present value that is below the 10-percent threshold. Note that the charitable gift must at least equal 10 percent of the amount given which precludes lifetime gifts to younger adult children.

15. Example 5: Charities as IRA Beneficiaries.

Harry and Sally have a $6 million estate that includes a $500,000 IRA. They want to benefit their church with a gift equal to approximately 10 percent of their estate. How should they structure the gift?

The answer is easy. The gift should include the balance of their IRA after both deaths. Because the church will not pay income taxes when the IRA is liquidated, the gift will be more tax-efficient than giving the IRA to Jack and Jill. The balance of the charitable gift can be made from other estate assets.

If Harry and Sally will have enough to live on while they are alive, they can give a portion of their IRA directly to charity. The funds need to be directly transferred to the charity by the IRA. The limit was $100,000[76] and, it is hoped, will be reinstated by Congress. The benefit of a direct IRA gift is that the charitable deduction created by withdrawing the funds and then making the gift is not subject to certain limitations on itemized deductions.

16. Example 6: Illiquid Taxable Estate Includes Large IRA.

Harry and Sally have an estate of $2 million. It consists of a $1 million IRA and $1 million in their home and personal investments. Harry owns the

[75] IRC § 664.
[76] IRC § 408(d)(8).

IRA, and Harry and Sally together own the other assets jointly. Although they will not be subject to the federal estate tax, they might be subject to the estate tax in their state, which has an exemption of $1 million. The state where they live follows federal law on most matters, such as the availability of the marital deduction and what assets are included in the taxable estate. How should they structure their estate?

Harry and Sally should restructure their assets so that Harry owns only the $1 million IRA (naming Sally as the primary beneficiary and Jack and Jill as the contingent beneficiaries) and Sally solely owns the remaining assets. If Sally dies first, she can transfer the $1 million in non-IRA assets to Harry in a bypass trust. When Harry dies, he will own the IRA for state estate tax purposes, but there will be no tax, since its value will not exceed the $1 million exemption. Harry will not be considered to own the assets in the bypass trust if it is properly drawn.

But what if Harry dies first? A clever approach is for Sally to give Harry a general testamentary power of appointment of up to $1 million in her assets.[77] At Harry's death, Harry's personal representative would then select virtually all of Sally's assets to satisfy his power of appointment. Harry's Will or revocable trust would then pass the non-IRA assets acquired from Sally under the power of appointment to a bypass trust for Sally's benefit. On Sally's later death, she would own only the IRA that she inherited from Harry for state estate tax purposes. Because these assets are valued at $1 million, there would be no state estate tax because of the $1 million exemption. If properly drawn, the assets in the bypass trust would not be included in Sally's estate. The essence of this approach is that the $1 million

[77] See Priv Ltr Rul 200403094.

of non-IRA assets does double duty, since it will be included in Harry or Sally's bypass trust, depending on who passed away first.

17. Example 7: Custodial Account When a Trust Won't Do.

Harry (a young widower) and his girlfriend visit his lawyer two days before going on a vacation cruise. Harry has two small children, Jack and Jill, by his deceased wife, Sally. Harry has a $400,000 IRA and total assets in the range of $1.2 million. He has decided that he must "do something" to protect the IRA for his children before leaving on vacation.

A custodial Uniform Gift to Minors Act ("UGMA") or a Uniform Transfer to Minors Act ("UTMA") account may be a good answer for smaller estates or if the participant for some reason does not want to establish a trust. It is quick and easy, especially if the adviser does not have time to draft a trust. Another advantage is that there is no need to prepare a tax return for a custodial account, while a trust must generally file a separate tax return. If there were two or more beneficiaries, the custodian could on a postmortem basis establish several separate IRAs for each beneficiary. If separate IRAs were not established, then the age of the oldest beneficiary would be the controlling life using the Single Life Table and the Reduce by 1 Method. Care must be taken because some states have limits on the amount passing to an UGMA or UTMA account.[78]

[78] The following is a designation example under the UTMA of a state that allows a custodian to hold assets for a beneficiary until the beneficiary is age 25. The form of designation has the advantage of establishing shares for each child or grandchild and using a UTMA custodian only for children or grandchildren who are under age 25: "All benefits payable under the plan or account as a result of my death are to be divided into shares with one share for each child of mine who survives me and with a share by right of representation for any child of mine who does not survive me, but leaves issue surviving me. Any share established for a beneficiary over age 25 is to be transferred to that beneficiary. Any share established for a beneficiary under age 25 is to be transferred to _____ as custodian for each such beneficiary under the _____ Uniform Transfer to Minors Act with ultimate distribution

18. Example 8: Comparison of Differences in Designations.

Harry has passed on before he reached age 70½. Sally inherits his $1 million IRA. Sally's father, coincidentally, also recently died and gave Sally a $1 million IRA. Here are just some of the various alternatives distribution choices Sally needs to face.

Description	Start Date	Table	Table Method
Inherited IRA from Harry	December 31 of year Harry would have been 70½	Single Life Table	Recalculate Annually
Roll over Harry's IRA to new IRA (same for Sally's own IRA)	April 1 of year after Sally is 70½	Uniform Lifetime Table	Recalculate Annually
Inherited IRA from Sally's Father	December 31 of year following Father's Death	Single Life Table	Reduce by 1 Method
Harry's IRA goes to Bypass or Marital **Conduit Trust** for Sally for life and then to Jack and Jill	December 31 of year Harry would have been 70½	Single Life Table	Recalculate Annually
Harry's IRA goes to Bypass or Marital **Accumulation Trust** for Sally for life and then to Jack and Jill	December 31 of year following Harry's Death	Single Life Table	Reduce by 1 Method

19. Conclusion.

Since retirement plans are America's largest investment asset, you would think that Congress would make it easy for the average Joe or Harry to do such simple things as give his plan benefits to his minor children. Because

deferred until age 25. If _____ cannot or will not serve as custodian, _____ is named as the successor custodian. My children's names are: _____, and I have no deceased children with or without surviving issue."

of the tax-deferred nature of retirement plan funds, however, participants and their families have learned that they can stretch out the time in which they are required to recognize taxable income on withdrawn funds. In response, Congress and the IRS have created a complex web of rules to satisfy the conflicting goals of providing retirement benefits for participants and their spouses, yet force plan withdrawals so that the deferral does not last forever and the government can eventually tax plan assets. Those rules allow the participant and his surviving spouse great flexibility in stretching out the receipt of plan funds, requiring only that withdrawals commence upon reaching age 70½.

The forgotten stepchild of all these competing goals is sound planning to manage plan assets for small children, for disabled persons, for persons who cannot manage their money, or in second-marriage situations. Seemingly nonsensical rules provide that a trust that has an extremely small chance that it might distribute to charity is still subject to the Default RMD Rule, which generally means income taxes on all the fund assets within five years. Other rules provide that if the trust accumulates income (at a very high tax rate) for the benefit of a protected person, it is subject to the adverse income tax consequences of the Default RMD Rule. But if the same trust were structured as a Conduit Trust, which is required to distribute the RMD to the trust beneficiaries (who might blow it on a new truck and a jet ski), the much friendlier Individual RMD Rule would apply. Why does Congress think this is a better result?

Nevertheless, this is the system that we must deal with and master. And a number of important rules of thumb can be distilled in the area of retirement plan designations:

- Stretch out the time when retirement plans are withdrawn in order to take advantage of the benefits of compounded tax-free earnings.

- If a participant's surviving spouse can afford it, give the retirement plan at death to a charity or grandchildren instead of the surviving spouse.

- If a surviving spouse inherits retirement funds, in almost every case it is advantageous to roll the IRA to a new IRA in which the surviving spouse is the participant.

- Designate benefits for potential children to a separate trust designed to meet the requirements for an Accumulation Trust or a Conduit Trust.

- If the trust is a special-needs trust, it should be structured as an Accumulation Trust.

- If a trust is needed for older adults because they are incapable of handling money, potential divorce, creditor claims, children from a prior marriage, or otherwise, it is tough to decide whether to use an Accumulation Trust or a Conduit Trust. In most situations, a Conduit Trust has no particular advantages over an Accumulation Trust. One advantage of a Conduit Trust is that potential contingent, remainder, successor and power-of-appointment beneficiaries are ignored. A second advantage is that if a trust is established for a surviving spouse, the trust can use the Recalculate Annually Method, and where the deceased

participant died before reaching 70½, RMD will be deferred until that date.

- If a bypass trust is established to save estate taxes, avoid allocating the retirement plan to the bypass trust.
- If multiple individual beneficiaries inherit retirement plan benefits, establish separate IRA accounts for each beneficiary.

While some basic rules are helpful, this is a complex area of tax law. There can be no substitute for carefully analyzing the desires of the parties, the law, and the facts before reaching a conclusion.

Required Minimum Distribution Rules (Except Roth IRA)

Beneficiary (Rule)	Note	Required Beginning Date	Measuring Life for RMD Purposes	Actuarial Table	Successor Applicable Life (Single Life Table used for any Designated Beneficiary—Reduce by 1 Method)
Participant (Participant RMD Rule)	No spouse or spouse is not 10 years younger than participant or not sole beneficiary	April 1 of year after participant is age 70½ or retirement (if under 5% owner and not for IRAs)	Participant	Uniform Lifetime Table—Recalculate Annually Method	See below for Spouse, Individual(s), or Nonpersons
	Spouse is sole beneficiary and is more than 10 years younger than participant	April 1 of year after participant is age 70½	Participant	Joint and Last Survivor Table—Recalculate Annually Method	See below for spouse, individual(s), or nonperson(s)
Spouse as sole beneficiary (Spouse RMD Rule)	Participant died before Age 70½	December 31 of year participant would have been age 70½	Spouse	Single Life Table—Recalculate Annually Method	Spouse's life (if both spouse and participant died before each RBD, use life of oldest Designated Beneficiary)
	Participant died after Age 70½	December 31 of year after participant's death	Younger of spouse or participant	Single Life Table—Recalculate Annually Method	Spouse's life (unclear if participant's life if participant was younger)
Spouse as sole beneficiary rolls over to new IRA	Spouse under age 70½	April 1 of year after spouse is age 70½	Spouse	Uniform Lifetime Table—Recalculate Annually Method	Successor
	Spouse over age 70½	December 31 of year after participant's death	Spouse	Uniform Lifetime Table—Recalculate Annually Method	Successor
Individual(s) (Individual RMD Rule)	Participant died before age 70½	December 31 of year after participant's death	Oldest Designated Beneficiary	Single Life Table—Reduce by 1 Method	Oldest Designated Beneficiary
	Participant died after age 70½	December 31 of year after participant's death	Younger of (i) oldest Designated Beneficiary or (ii) participant	Single Life Table—Reduce by 1 Method	Oldest Designated Beneficiary (unclear if participant's life if participant was younger)
Nonperson(s) (Default RMD Rule)	Participant died before age 70½	Distribution must be completed within 5 years of participant's death	Not applicable	Not applicable	Not applicable
	Participant died after age 70½	December 31 of year after participant's death	Participant	Single Life Table—Reduce by 1 Method	Participant

Roth IRA Required Minimum Distribution Rules

Beneficiary (Rule)	Note	Required Beginning Date	Measuring Life for RMD Purposes	Actuarial Table	Successor Applicable Life (Single Life Table used for any Designated Beneficiary—Reduce by 1 Method)
Participant (Participant RMD Rule)	No distribution required				See beneficiary rules for spouse, individual(s), or nonperson(s)
Spouse as sole beneficiary (Spouse RMD Rule)		December 31 of year participant would have been age 70½	Spouse	Single Life Table—Recalculate Annually Method	Spouse's life (if both spouse and participant died before each RBD, use life of oldest Designated Beneficiary)
Spouse as sole beneficiary rolls over to new IRA	No distribution required				See beneficiary rules for spouse, individual(s), or Nonperson(s)
Individual(s) (Individual RMD Rule)		December 31 of year after participant's death	Oldest Designated Beneficiary	Single Life Table—Reduce by 1 Method	Oldest Designated Beneficiary
Nonperson(s) (Default RMD Rule)		Distribution must be completed within 5 years of participant's death			

Chapter 5

NEW OREGON ESTATE TAX

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I. INTRODUCTION

The 2011 legislature made significant changes to the Oregon inheritance tax, which became effective for decedents dying on or after January 1, 2012. The tax imposed by the new law is now known as the Oregon estate tax.

These materials are divided into four sections:

1. An introduction, including a discussion of the terminology applicable to both the old inheritance tax and the new estate tax;
2. A discussion of the new law adopted in 2011, effective for deaths after 2011;
3. A discussion of the old law applicable to deaths before 2012; and
4. A discussion of the procedural law applicable to both the old and new statutes.

In these materials, references to sections of the Oregon revised statutes are to both the new and old versions of the law. In discussion of the new law, the references are to the 2011 law. In discussions of the old law, references are to the 2009 statutes. When discussions of both the old and new law are combined, citations to the ORS will specify either 2009 or 2011 law where it makes a difference.

These materials are an abbreviated version of Chapter 14 of *Administering Oregon Estates* by Philip N. Jones and Jeffrey M. Cheyne (OSB Legal Pubs 2012). Portions of these materials are based on materials previously prepared by Holly N. Mitchell.

These materials are based on the Internal Revenue Code, federal regulations, the Oregon Revised Statutes, Oregon Administrative Rules, and reported state and federal cases. Before relying on any statements in these materials, please review current statutes, regulations, rules, and case law to determine if any changes have occurred.

A. A Brief History

The first inheritance tax was adopted in Oregon in 1903, with an initial rate that varied from 1% to 6% depending on the degree of kinship and the amount inherited. 1903 HB 41. In 1971, a "pickup tax" equal to the federal credit for state death taxes was enacted in Oregon as a floor to the Oregon tax, and the rates then varied from 2% to 20%. 1971 Oregon Laws Ch. 732. After 1971, the legislature regularly reconnected to changes in the federal law. By 1975, the rates varied from 3% to 25%. ORS 118.100 (1975). Those rates ended in 1977, when the Oregon legislature adopted an inheritance tax equal to the greater of (a) a flat 12% rate after applying an exemption, or (b) the federal state death tax credit. 1977 Oregon Laws Ch. 666. The 1977 legislation also scheduled the end of the 12% rate by January 1, 1987, when the Oregon inheritance tax became a pure pickup tax equal to the federal state death tax credit. ORS 118.100(1)(b) (1977).

In 1997, the legislature reenacted the pickup tax and repealed the Oregon gift tax, which had been enacted in 1933. 1997 Oregon Laws Ch. 99 §7; 1933 Oregon Laws Ch. 427. As a result, Oregon reconnected its

inheritance tax to the Internal Revenue Code as amended by the federal Taxpayer Relief Act of 1997, which had scheduled an increase in the federal unified credit from $600,000 in 1997 to $1,000,000 in 2006 and years thereafter. (As explained in greater detail below, those unified credit amounts remained in place through 2011 for purposes of calculating the federal Table A cap on the Oregon inheritance tax.)

In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA"), which began the scheduled increases of the federal unified credit that would eventually reach $3,500,000 in 2009, phased out the federal state death tax credit by 2005, and caused the repeal of the Oregon inheritance tax, which was based on the amount of the federal credit. The Oregon legislature balked at following the federal exemption increases and declined to reconnect to the newly amended Internal Revenue Code. Instead, in 2003 the Oregon legislature enacted 2003 HB 3072 (2003 Oregon Laws Ch. 806), which froze Oregon's connection to the Internal Revenue Code as of December 31, 2000. ORS 118.007 (2009). As a result, Oregon decoupled from later changes in the federal estate tax. In effect, Oregon adopted an exemption beginning at $700,000 in 2003 and climbing to $1,000,000 in 2006 and years thereafter. That 2003 Oregon legislation also adopted a $1,000,000 filing threshold for 2002, followed by a $700,000 filing threshold in 2003 that eventually grew to $1,000,000 in 2006, in accordance with pre-EGTRRA 2001 scheduled increases in the federal unified credit. An Oregon-only QTIP election was also authorized. ORS 118.010(7) (2009).

The nature of this freeze or decoupling is described in *Force v. Dept. of Revenue (Estate of Pierson),* 350 Or. 179, 252 P.3d 206 (2011).

During the interim period between 2001 and 2003, some strange results took place in the Oregon inheritance tax because of the interplay between the Oregon filing threshold and the federal unified credit. For example, under HB 3072 if a decedent died in 2002 with a taxable estate of $999,999, no Oregon tax would be due because of the Oregon filing threshold, but if the decedent had had a taxable estate of $1,000,000 (only one dollar higher), an Oregon tax of $33,200 would be due. That odd (and unintended) result came about because HB 3072 provided that an Oregon inheritance tax return was not required for taxable estates of less than $1,000,000, but the unified credit equivalent for 2002 was fixed by HB 3072 at only $600,000. 2003 Oregon Laws Ch. 806 §10. Estates of slightly more than $1,000,000 similarly paid an Oregon tax of slightly more than $33,200 but not less than that amount. This "cliff effect" is no longer present.

As a result of the 2003 legislation, Oregon employed an inheritance tax that required four calculations that are discussed below, in the section describing the old law.

This bizarre tax (or the bizarre four-part calculation of this tax) was simplified by House Bill 2541, adopted by the 2011 legislative session. The new law is effective for decedents who died on or after January 1, 2012. It imposes a wholly new standalone state estate tax that does not follow the federal exemptions.

The 2011 legislature changed the name of the tax to the Oregon estate tax, rather than the Oregon inheritance tax. Among the many changes made, the dual (Table A—Table B) nature of the calculation was eliminated, the four steps described above were eliminated, a $1,000,000 exemption was adopted, and a new rate table was enacted, ranging from 10% to 16%. In addition, the new law changed the date of the tie-in to the federal estate tax to December 31, 2010, rather than December 31, 2000, under the old law. ORS 118.007.

As a result of the 2011 legislative changes, the Oregon Department of Revenue is in the process of revising and updating many of the Oregon Administrative Rules applicable to ORS Chapter 118 and will issue revised forms and instructions from time to time. The new forms and instructions will be available on its website, www.oregon.gov/DOR.

B. Terminology

The following terminology applies to both the old inheritance tax and the new estate tax, except where noted. In reviewing these definitions, keep in mind that the old Oregon inheritance tax was tied to the federal estate tax as the federal statutes existed on December 31, 2000, while the new Oregon estate tax is tied in as of December 31, 2010. ORS 118.007. Thus, where relevant, the Oregon estate tax ties to provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Public Law 111-312), which became effective on December 17, 2010.

1. Gross Estate. The total value of all assets (worldwide), without any reduction for debts, expenses, or other deductions. The gross estate is the same for both federal and Oregon purposes. ORS 118.005(6) (2011). The filing thresholds for both federal and Oregon purposes are measured against the gross estate to determine whether a return is required to be filed. ORS 118.160(1).

2. Filing Threshold. The value of the gross estate above which a return is required to be filed. The Oregon filing threshold has been $1,000,000 since 2006. ORS 118.160(1)(b)(D) and ORS 118.160(1)(c) (2011). Because of revenue implications, the Oregon filing threshold is not scheduled to change. The federal filing threshold for 2008 was a gross estate of $2,000,000. In 2009, the federal filing threshold was a gross estate of $3,500,000. The federal tax was bifurcated in 2010, with estate representatives having a choice between a $5,000,000 exemption or no federal estate tax. In 2011, the filing threshold was $5,000,000, with the exemption indexed in 2012 to $5,120,000.

3. Deductions. Include debts, administration expenses, marital bequests, charitable bequests, funeral expenses, and other items. Deductions are usually slightly different for Oregon and federal purposes. For example, the Oregon inheritance tax is allowed as a deduction for federal purposes (IRC §2058) but not for Oregon purposes.

4. Federal Taxable Estate. The gross estate minus deductions. §2051. The federal taxable estate is usually different than the Oregon taxable estate. In general terms, the federal taxable estate is the amount that is multiplied by the federal rate tables to calculate the federal estate tax (the exception to that statement is when adjusted taxable gifts have been made).

5. Oregon Taxable Estate. The 2011 law, for the first time, specifically adopted the phrase "Oregon taxable estate" and defined it. ORS 118.005(7) (2011). The Oregon taxable estate is defined as the federal taxable estate, as adjusted by ORS 118.010(3) (2011). Those adjustments include ignoring the state death tax deduction under IRC §2058, adding back in OSMP property from a prior estate (unless already included in the federal estate), adding back in marital deduction and QDOT property from a prior estate, but subtracting OSMP property claimed in this estate and other exclusions and deductions. ORS 118.010 (2011).

6. Adjusted Taxable Gifts. Cumulative gifts made in excess of the annual exclusion. IRC §2001(b); §2503

7. Tentative Tax. The federal estate tax before the application of the unified credit.

8. Adjusted Taxable Estate. The Oregon taxable estate minus $60,000. IRC §2011(b)(3). This is the amount on which the Table B Oregon inheritance tax is calculated under old Oregon law. This amount does not include adjusted taxable gifts. The term "adjusted taxable estate" is no longer used in connection with the calculation of the federal estate tax, and it is not used in connection with the new Oregon law.

9. State Death Tax Credit. This federal credit has been fully phased out for deaths occurring after 2004. IRC §2011(b)(2)(B). For federal purposes, it has been replaced by a deduction. IRC §2058. However, the old state death tax credit rate table is still used to calculate the old Oregon inheritance tax. ORS 118.010(2) (2009). The state death tax credit rate table is shown as Table B in the IT-1 instructions for deaths prior to 201

II. THE NEW POST-2011 OREGON ESTATE TAX

Beginning with deaths on or after January 1, 2012, the new Oregon estate tax will apply, and a new tax return form (OR706) will be required.

A. Calculating the Oregon Estate Tax

With the repeal of the two-table tax calculations (Table A and Table B), the computation of the Oregon estate tax will be simpler, since only one tax table is used. There is no longer any need to determine the adjusted taxable gifts for the Table A tax calculation or the adjusted taxable estate for the Table B tax calculation.

The purpose of this section is to walk through, step by step, the process to determine the new Oregon estate tax.

1. Step 1—Determine the Gross Estate. The first step is to identify the decedent's worldwide assets and then determine the total value of those assets. This includes all of the decedent's assets, both in Oregon and outside of Oregon. These worldwide assets constitute the "gross estate" under section 2031 of the Internal Revenue Code and ORS 118.005(6) (2011)

2. Step 2—Determine If an Oregon Estate Tax Return Is Required. If the value of the gross estate is less than $1,000,000, then no Oregon estate tax return is required to be filed. ORS 118.160(1)(c) (2011).

However, since the gross estate includes the value of a decedent's worldwide assets, it is possible for a resident or nonresident decedent estate with assets located in Oregon worth substantially less than $1,000,000 to still be subject to the filing requirement because the gross estate value is over $1,000,000. Thus, a nonresident decedent with a deeded time-share interest in a beach property at the Oregon coast and a worldwide gross estate value over $1,000,000 would be subject to an Oregon estate tax return filing requirement, even though the value of the property located in Oregon is worth substantially less than $1,000,000.

If the value of the gross estate is $1,000,000 or more, then an Oregon estate tax return is required, and it is due on the date the federal estate tax is payable; or if no federal estate tax return is required, the Oregon estate tax return is due nine months after the date of the death of the decedent. ORS 118.100(1) and 118.160(1)(c) (2011). Six-month and other extensions of time to file the return are discussed below.

3. Step 3—Determine the Federal Taxable Estate. If an Oregon estate tax return is required, then the next step is to determine the federal taxable estate, which is defined above and is specifically referenced by the Oregon estate tax law. ORS 118.005(5) (2011). The federal taxable estate is, generally, the gross estate minus the applicable deductions that are available on a federal estate tax return. If no federal estate tax return is required, then the representative of the estate must nevertheless complete a federal estate tax return, because the schedules from the federal estate tax return must be attached to the Oregon estate tax return.

4. Step 4—Determine the Oregon Taxable Estate. After the amount of the federal taxable estate is determined, the next step is to determine the Oregon taxable estate by making the adjustments provided in ORS 118.010(3) (2011). ORS 118.005(7) (2011). The Oregon taxable estate is defined above, and generally it provides additions and deletions to the federal taxable estate to arrive at the Oregon taxable estate. The Oregon taxable estate includes the value of the decedent's worldwide assets and worldwide deductions.

5. Step 5—Calculate the Preliminary Oregon Estate Tax. Once the Oregon taxable estate is determined, the preliminary Oregon estate tax can be calculated. ORS 118.010(4) (2011). If the Oregon taxable estate is less than $1,000,000, the Oregon estate tax is zero. If the Oregon taxable estate is $1,000,000 or more, the tax rate begins at 10% for the

first dollar over $1,000,000 and then incrementally increases from 10% to a maximum of 16% for Oregon taxable estates over $9,500,000 million. Assuming that a decedent died in 2012 with an Oregon taxable estate of $4,500,000 million, the preliminary Oregon estate tax would be $367,500.

6. Step 6—Determine the Actual Oregon Estate Tax. If the decedent was domiciled in Oregon at the time of his or her death and no real or tangible personal properties were located outside of Oregon, then the Oregon estate tax on a taxable estate of $4,500,000 would be $367,500. If the decedent was domiciled in Oregon but had real or tangible personal property located outside of Oregon or had intangible personal property subject to a death tax in another state or country, then the preliminary Oregon estate tax would be subject to the fractional adjustment discussed in the section titled "Residents vs. Nonresidents," below. ORS 118.010(5) (2011). If the decedent was not domiciled in Oregon at the time of his or her death but had real property or tangible personal property located in Oregon, then the preliminary Oregon estate tax would be subject to a fractional adjustment, also discussed in the section below titled "Residents vs. Nonresidents" *Id.*

The Oregon estate tax is due when the federal estate tax is payable, or if no federal estate tax return is required, the Oregon estate tax is due nine months after the date of the death of the decedent. ORS 118.100(1) (2011). Requests for extensions to pay the tax are discussed below.

The Oregon tax form for reporting 2012 estates will change. The Form IT-1 will not be used for 2012 estates. Instead, the form will be changed, and its new name will be the 2012 Oregon Form OR706. The title of the new form will be Oregon Estate Transfer Tax Return. The final version of the Oregon form for 2012 estates is not expected to be available until September 2012.

B. Lifetime Gifts

With the old pre-2012 Oregon inheritance tax, the decedent's lifetime gifts in excess of the annual exclusion amounts, which are described as "adjusted taxable gifts," were taken into account in a complicated way. In contrast, the new Oregon estate tax ignores adjusted taxable gifts, because neither the gross estate nor the federal taxable estate include those gifts in their definitions. IRC §2001(b).

This presents a significant lifetime planning opportunity. An elderly person with an estate of $4,900,000 (just below the federal unified credit of $5,120,000 in place as of this writing) could make a gift (deathbed or otherwise) of $4,000,000 to her children. The gift would not be taxable for federal gift tax purposes because the gift would be within the $5,120,000 federal lifetime gift exclusion. Although the gift would be brought back into the federal estate as an adjusted taxable gift, the total estate of the decedent would be below the federal estate tax unified credit of $5,120,000. More importantly, the decedent would die with a gross estate of $900,000, which is below the Oregon filing threshold. ORS 118.160(1)(c) (2011). As a result, no federal estate or gift tax would

be due, and no Oregon estate tax would be due. The Oregon tax savings would be $380,400 under the old law and $413,500 under the new law.

In the above illustration, significant tax savings would be experienced even if the gift were not successful in reducing the Oregon estate below the filing threshold. If the decedent in the above illustration had given away only $3,000,000, rather than $4,000,000, her Oregon taxable estate would be $1,900,000, rather than $900,000. In that situation, the resulting Oregon estate tax would be $91,000. Had the gift not been made, the resulting estate tax under the new law would have been $413,500, for a tax savings of $322,500.

Be careful, however, because the gift-tax savings from this sort of deathbed gift may be offset by the loss of a stepped-up basis for income-tax purposes. Lifetime gifts generally do not receive a stepped-up income tax basis at death. In contrast, most assets transferred at death do receive a stepped-up basis. Consider, for example, a $1 million gift in 2012 by the elderly person described above. The Oregon estate tax savings would be $112,000. If the assets given away had an income tax adjusted basis of $100,000, the donee would acquire the assets with that same low basis of $100,000. Later, when the donee sells the gifted assets for $1,000,000, a taxable gain of $900,000 would be realized. Using a combined Oregon and federal income tax rate of 24.5%, the combined income taxes would be $220,500, almost double the Oregon estate tax savings.

C. Residents vs. Nonresidents

Oregon taxes resident decedents on all types of property (tangible and intangible) wherever situated. *The tax is calculated on the entire Oregon taxable estate (wherever located), and then the tax is multiplied by a fraction,* the numerator of which is the sum of (1) real property located in Oregon, (2) tangible personal property located in Oregon, and (3) intangible personal property wherever located (but excluding intangible personal property subject to a death tax in another state or country). The denominator is the entire gross estate. ORS 118.010(2)(a) and (5).

Nonresident decedents are taxed based on the proportional value of real and tangible personal property located in Oregon. Thus, *the tax is calculated on the Oregon taxable estate (which includes Oregon and non-Oregon assets, both tangible and intangible), and then the tax is multiplied by a fraction,* the numerator of which is the value of the Oregon tangible personal property and the Oregon real property (but no intangible property), and the denominator is the entire gross estate. ORS 118.010(2)(b) and (6).

Unlike the old Oregon inheritance tax, nonresidents are no longer taxed on intangible property located in Oregon. That change greatly simplifies the calculation of the tax. It also avoids two murky issues present under the old law: whether an asset constitutes intangible personal property located in Oregon and whether a nonresident's home state taxes intangible personal property of Oregon decedents.

In short, under the new Oregon statutory scheme, tangible property (both real and personal) will be taxed only by the state in which it is located. This is true for both resident and nonresident estates. Intangible personal property held by resident estates will be taxed regardless of location, except that intangible personal property subject to a death tax in another state or country will be excluded from the numerator of the fraction. ORS 118.010(5). Intangible personal property held by nonresident estates will not be taxed. ORS 118.010(2), (5), and (6).

These statutes can produce some unexpected results. As noted above, the filing threshold of $1,000,000 is based on the gross estate, regardless of where the assets of the gross estate are located. ORS 118.160(1)(b)(D). As a result, a nonresident with a gross estate of $1,000,000 or more, but with a small amount of Oregon tangible assets, will be required to file an Oregon estate tax return and will be required to pay Oregon estate tax if the taxable estate exceeds $1,000,000, even if the state of residence imposes no estate or inheritance tax.

For example, if an Oregon resident moves to California (which has no estate or inheritance tax) but leaves behind in Oregon either real property or tangible personal property, that person's estate will be subject to Oregon estate tax if the taxable estate (wherever located) exceeds $1,000,000. The same result will take place if the person never lived in Oregon but happens to own real or tangible personal property in Oregon. *Because of the fractional method of calculating the tax, even a small amount of Oregon tangible property will trigger a tax.*

If all of the Oregon property of a nonresident passes to a surviving spouse or to a charity, the Oregon estate tax on nonresidents is not necessarily eliminated. Marital deductions and charitable deductions, like all other deductions, reduce the taxable estate, not the gross estate, and the fractional formula employs the gross estate as its denominator and the gross estate located in Oregon as its numerator. The fact that some or all of the numerator passes to a spouse or a charity does not affect the fraction or the resulting percentage. Marital deductions and charitable deductions will reduce the overall Oregon tax, but they will not reduce the percentage of the tax payable to Oregon, nor will they reduce the assets (the gross estate) to be measured against the filing threshold. As a result, the amount of tax payable to Oregon will remain the same regardless of whether Oregon assets or foreign assets pass to the spouse or to charity (assuming that the value passing to the spouse or to charity remains the same).

As a further example, if the surviving spouse was an Oregon resident when the first spouse died but then moves to California (which has no estate or inheritance tax) but is the beneficiary of a state QTIP trust or an OSMP trust that holds either Oregon real property or Oregon tangible personal property, that surviving spouse's estate will be subject to Oregon inheritance tax if the taxable estate (wherever located) exceeds $1,000,000.

The same result occurs if the Oregon property is subject to an encumbrance. The encumbrance reduces the taxable estate, but it does

not reduce the amount of the gross estate in Oregon, nor does it reduce the gross estate located elsewhere. Thus, it is possible to owe Oregon inheritance tax on a nonresident estate even when the net value of the Oregon assets is negative due to an encumbrance on the Oregon assets.

Equally puzzling is the fact that the legislature drafted the statute in a manner that reflects a determination by the legislature that personal property of a nonresident can have a situs in Oregon. Yet the Oregon Court of Appeals has held in a probate case that the personal property of a nonresident decedent has the same situs as the decedent's domicile. *West v. White*, 92 Or. App. 401 (1988). Although the *West* case dealt with an intangible (a promissory note), the holding is not limited to intangible personal property.

Keep in mind, however, that no Oregon estate tax return will be due (and no tax will be due) if the worldwide gross estate of the decedent is less than the filing threshold of $1,000,000. ORS 118.160(1)(b)(D).

The bottom line: nonresident clients with even a small amount of Oregon tangible assets should review their situation in order to determine whether steps should be taken to minimize or eliminate the Oregon estate tax. Those steps might include disposing of Oregon assets or moving the Oregon assets to another state, such as the state of residence, depending on the estate or inheritance tax laws of the state of residence. Or a nonresident might consider placing Oregon tangible property into an entity created in another state, such as a limited liability company, although the efficacy of that technique is not clear. Even Oregon residents can reduce their Oregon estate tax by holding tangible assets in other states, but the amount of overall tax savings will depend on the inheritance tax laws of those other states.

Nonresident surviving spouses who are beneficiaries of a state QTIP trust or an OSMP trust present an interesting challenge. If the surviving spouse moves to another state such as California, and the state QTIP trust or OSMP trust then liquidates all of the Oregon property held in trust, what part, if any, of the surviving spouse's estate is reportable in Oregon? Even though the trust holds no Oregon property at the time of the surviving spouse's death, ORS 118.010(3)(a)(B) requires that the property in a state QTIP or OSMP trust be included in the Oregon taxable estate. When the surviving spouse dies, it is unclear whether the entire value of property held in a state QTIP or OSMP trust is treated as Oregon property because it was claimed as a deduction in the first deceased spouse's estate. A number of practitioners believe that a nonresident is taxable in Oregon only to the extent the estate holds real or tangible personal property located in Oregon; thus, no tax would be due. ORS 118.010(2)(b). Thus, even if the Oregon taxable estate exceeds $1,000,000, the Oregon estate tax should be zero in the example described above, because the numerator of the fraction would be zero. The Department of Revenue is considering an administrative rule, 150-118.010(8), which specifies that a nonresident is taxable in Oregon only to the extent that a QTIP trust holds real or tangible personal property located in Oregon. This rule, if adopted, should become effective in July or August 2012.

The administrative rules of the Department of Revenue should be reviewed periodically to determine the status of this rule and others.

D. Effective Date of the New Law

Technically, the effective date for HB 2541 is September 29, 2011; however, except for the revisions to ORS 105.645 (the taxable disclaimer statute), all of the other provisions of the bill apply to estates of decedents who die on or after January 1, 2012. Thus, the current law (ORS 2009 provisions) still applies for 2011 decedents. A copy of the new legislation can be found at http://www.leg.state.or.us/11orlaws/sess0500.dir/0526.pdf. When this bill was introduced in the House Revenue Committee, the Oregon Law Commission prepared a comprehensive Work Group Report, which can be found at http://www.willamette.edu/wucl/olc/groups/2007-2009/pdf/Inher.%20Tax%20Report%20Approved%20on%20Letterhead%203.28.11.pdf. Note: the OLC report does not discuss the amendments that were made by the Senate.

E. Oregon Portability Election

Question: Can the estate of the first spouse to die during 2011 or 2012 make a portability election under Oregon law to pass the unused portion of the deceased spouse's $1 million Oregon exclusion amount to the surviving spouse? Conclusion: No. However, if both spouses die during 2012, there is a *possible* argument that the estate of the first spouse can make a portability election to include the deceased spouse's unused exclusion amount (DSUEA) to reduce the Oregon taxable estate of the surviving spouse. The resolution of such an election will likely have to be litigated in the Oregon courts.

1. The Portability Election Under Federal Law. IRC 2010(c) was amended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 to give the executor of the estate of the first spouse to die the elective right to pass the DSUEA to the surviving spouse to use in addition to the surviving spouse's applicable exclusion amount. In order to make this election, the executor of the estate of the first deceased spouse must timely file a federal Form 706 Estate Tax Return. The 2010 Act became effective on December 17, 2010.

The election to claim the DSUEA is available only if the first spouse dies in 2011 or 2012. In order to use the DSUEA, the surviving spouse must either (a) make lifetime gifts *during* 2011 or 2012 *but after* the first spouse dies, or (b) die *during* 2011 or 2012 *but after* the first spouse dies.

2. Oregon Portability. The Oregon portability question arises because the Oregon estate tax was recently tied to the Internal Revenue Code in effect on December 31, 2010. The relevant Oregon Revised Statutes, ORS 118.007 and 118.010(3) as amended by HB 2541(Oregon Laws 2011, Chapter 526), provide:

> Any term . . . has the same meaning as when used in a comparable context in the laws of the federal Internal Revenue Code relating to federal estate taxes, unless a differ-

> ent meaning is clearly required or the term is specifically defined in ORS 118.005 to 118.840. Any reference in ORS 118.005 to 118.840 to the Internal Revenue Code means the federal Internal Revenue Code as amended and in effect on *December 31, 2010*, except where the Legislative Assembly has specifically provided otherwise.

ORS 118.007 (Oregon Laws 2011, Chapter 526, Section 2) (emphasis added).

ORS 118.010(3) was amended to add provisions describing the components for determining the Oregon taxable estate, which provide for the reduction of the Oregon taxable estate by "any other applicable exclusions." ORS 118.010(3), as redacted, provides:

> (3) The Oregon taxable estate to be used for purposes of computing the tax imposed under this section shall be the federal taxable estate:
>
> (a) Increased by: . . . ; and
>
> (b) Reduced by: . . .
>
> (B) *Any other applicable exclusions* or deductions.

ORS 118.010(3) (Oregon Laws 2011, Chapter 526, Section 3) (emphasis added).

Since there are no limiting provisions in ORS 118.005 to 118.840, it is arguable that the "any other applicable exclusions" language in ORS 118.010(3) includes the DSUEA under IRC 2010(c). Thus, under ORS 118.010(3)(b)(B) as amended by HB 2541, if the first spouse and the surviving spouse both die in 2012, and a timely Form 706 is filed for the estate of the first deceased spouse, then the DSUEA could be claimed by the second spouse's estate for the full federal DSUEA. This would mean that up to $5,120,000 or the remaining DSUEA, if less, could be claimed on the Oregon estate tax return of the surviving spouse. It should be noted that this outcome was not intended by the Oregon Inheritance Tax workgroup, the ODR, or the Oregon legislature. Also, this argument does not apply if either spouse dies in 2011, because the December 31, 2010, IRC tie-date applies only to estates of decedents who die on or after January 1, 2012.

The ODR has not issued any published determination regarding the applicability of the federal portability election as it applies to Oregon law. However, in a recent email an ODR representative issued the following response:

> The department understands that "any other applicable exclusions or deductions" as used in ORS 118.010(3)((b)(B) could possibly be challenged by an estate to include the federal portability provision of IRC 2010(c)(2), (3), (4) and (5) based on the plain language of the statute. However program believes the legislature clearly did not intend to tie to the federal portability provision because without a statutory provision that identifies a basis exclusion amount

> for Oregon purposes, Oregon would tie to the federal basic exclusion amount identified in IRC 2010(c)(3) which is $5 million. A tie to the federal provision would obviously not be revenue neutral which was a goal of the legislature as evidenced by LRO's Revenue Impact Statement dated June 9, 2011 that shows the expected revenue impact for the legislation to be near zero.
>
> Program believes there would need to be a legislative change in order for Oregon to adopt a portability provision. Thanks for bringing the question to the department's attention and thanks in advance for communicating the department's position on this issue to practitioners.

Thus, the portability election is generally not available to increase the Oregon exemption of the surviving spouse's estate. A possible exception could occur when both spouses die in 2012, but such an election will probably be challenged by the ODR. The ODR would likely argue that the "unless a different meaning is clearly required" limiting provision of ORS 118.007 applies to limit the applicability of the DSUEA exemption from being added to the $1 million Oregon estate tax exemption of the surviving spouse's estate.

If the federal estate tax law is amended to extend the federal portability provisions beyond 2012, then it may make sense to consider whether the Oregon estate tax law should be amended to include express portability provisions so that a surviving spouse can use the deceased spouse's unused Oregon exemption. Until then, the ODR will likely not recognize any election for a surviving spouse to use the deceased spouse's unused Oregon exemption.

F. Natural Resource Credit Under the New Law

1. Background. In 2007, the Oregon legislature enacted ORS 118.140 to provide state tax relief to natural resource property owners. The section granted a $7.5 million Oregon inheritance tax exemption for natural resource property that is transferred to a family member. This legislation was drafted late in the session, and there were a number of unresolved questions. Some of those questions were resolved in the 2008 special legislative session, when the $7.5 million exemption was changed to a credit. Also, the concept of working capital was added as part of the natural resource property eligible for the natural resource credit, but working capital was not defined. ORS 118.140(2)(a)(D) (2009).

In 2008, ODR adopted an administrative rule defining "working capital" as "current assets less current liabilities." OAR 150-118.140(1)(g). This definition did not easily mesh with the working capital practices used by natural resource owners, because in many cases working capital balances had to be sufficient to carry a natural resource business for several years through up years and down years before the business operation started producing sufficient revenue to cover expenses.

Legislators tried unsuccessfully to resolve this issue during the 2009 legislative session. HB 3305 of that session died in the House Rev-

enue Committee. Then Representative Vicki Berger, the Legislative Revenue Office, and several other legislators, including the chairs and other members of the House and Senate Revenue Committees, requested that the Oregon Law Commission conduct a law reform project regarding Oregon's inheritance taxation laws. The request included a review of the natural resource credit. A work group was formed in 2009. After several months of deliberations, HB 2541 was presented to the House Revenue Committee during the 2011 legislative session. After being amended by both houses, it became law on June 28, 2011.

2. Natural Resource Property Definitions. Under the old law, one had to review approximately six different statutes to determine whether the nature and use of the property would qualify as natural resource property. ORS 118.140(1) (2009). Instead, the definitions under the new law are more self-contained. The natural resource property must be used in a "farm business," "fishing business," or "forestry business" (together referred as "natural resource business") ORS 118.140(1) (2011). The definitions of real property and personal property that qualify as natural resource property are broadly defined, so generally any property reasonably and customarily used in the natural resource businesses described in the statute will qualify as natural resource property. ORS 118.140(1)(i) (2011).

3. Operating Allowance Rather Than Working Capital. Because of the practical difficulties with its definition, the term "working capital" was replaced with the term "operating allowance." An operating allowance means cash and cash equivalents spent, maintained, used, or available for the operation of a farm business, forestry business, or fishing business and not spent or used for any other purpose. ORS 118.140(1)(j). The operating allowance may not exceed the lesser of 15% of the claimed natural resource property (excluding the operating allowance itself) or $1,000,000. ORS 118.140(2)(a). It may be claimed as natural resource property. ORS 118.140(1)(I). The concept of an operating allowance more closely matches the operating life cycle of natural resource businesses: cash may accumulate after crop, forest, or livestock sales, or as savings to buy equipment or other property, only to be disbursed during the crop production process.

4. Use and Transfer Requirements. The natural resource property must be transferred to a family member (as defined in IRC 2032A) of the decedent. For five out of eight years ending on the date of decedent's death, the decedent or a family member must have operated a natural resource business and used the natural resource property in the natural resource business. ORS 118.140(3)(c)–(d), (5), (6) (2011). Natural resource property that is leased to or from a family member or property held in trust for a family member who is a qualified beneficiary (as defined by ORS 130.010, ORS 118.140(1)(k) (2011)) continues to qualify. ORS 118.140(4)(b) (2011). Natural resource property owned in a limited liability company, corporation, partnership, or trust in which at

least one family member materially participates will continue to qualify. ORS 118.140(8) (2011).

5. Adjusted Gross Estate. The term "adjusted gross estate" ("AGE") was added to the statute as a defined term, since there are three natural resource computational requirements that are based on the value of the adjusted gross estate. The AGE is defined as the value of the gross estate reduced by the deductions under IRC 2053 (expenses, indebtedness, and taxes) and 2054 (losses during administration). ORS 118.140(1)(a) (2011). The AGE is used to determine the natural resource credit as a fraction of the Oregon estate tax, the maximum value of the adjusted gross estate that is eligible to claim the credit, and the 50% of the total estate requirement. No more than $7,500,000 in value can be claimed as natural resource property. ORS 118.140(2)(b). In order to claim the credit, the total adjusted gross estate cannot exceed $15,000,000, and the total value of natural resource property in the estate must equal at least 50% of the total adjusted gross estate. ORS 118.140(3) (2011).

6. Calculating the Natural Resource Credit. Rather than using the old credit table, the new credit is calculated as a fraction of the Oregon estate tax. The amount allowed as a natural resource credit is determined as follows.

a. First, determine the Oregon estate tax.

b. Second, determine the value of the natural resource property that is claimed under ORS 118.140(2)(b) (2011). The value of natural resource property can exceed $7,500,000, but the value claimed on the estate tax return schedule cannot exceed $7,500,000. Also, the executor may claim less than the full amount and may apply the credit value to specific assets. ORS 118.140(2)(b)–(c) (2011).

c. Third, determine the AGE and then determine the ratio of the claimed natural resource property as the numerator over the AGE as the denominator.

d. Fourth, determine the natural resource credit by multiplying the ratio times the Oregon estate tax.

7. Natural Resource Property Replacement Transfers. Generally, natural resource personal property, tangible or intangible, can be replaced with other intangible or tangible personal property and still qualify for the credit if it continues to be used in the natural resource business. ORS 118.140(4)(c), (9)(d) (2011). However, if natural resource real property is transferred after the decedent's death but before the estate tax return is filed, it must be replaced with natural resource real property, and it will continue to be eligible for the credit. ORS 118.140(4)(c) (2011). If natural resource real property is replaced with natural resource real property before the decedent's death pursuant to an IRC 1031 exchange or an IRC 1033 conversion, the holding period for the previously owned property may be included for purposes of satisfying the five-out-of-eight-year requirement. ORS 118.140(7) (2011). In the case of the replacement of real property claimed as a credit, it must be replaced with real property within one year in order to continue to qualify, unless

the replacement property is acquired within two years as a result of an involuntary conversion pursuant to IRC 1033. ORS 118.140(9)(d) (2011). In order to continue to qualify, any natural resource replacement property must continue to be used in a natural resource business. *Id.*

8. Disposition Tax and Other Taxable Transfers. If natural resource property is sold or is no longer used in a natural resource business prior to being utilized for five out of the eight calendar years following the decedent's death, a "disposition" occurs and an additional tax is due. ORS 118.140(9)(a) (2011). The additional tax is prorated to reflect a reduced tax applicable to the portion of the five-year period remaining unused, and the additional tax is due within six months after the date of disposition or cessation of use. ORS 118.140(9)(e) (2011). Also, the use of cash or other natural resource assets to pay federal estate taxes or state inheritance or estate taxes constitutes a disposition. ORS 118.140(9)(b) (2011).

9. Annual Reporting Requirement. The transferees who received natural resource property for which a credit was claimed must file annual reports with ODR regarding the status of the claimed natural resource property by indicating the following status categories applicable to each asset: (a) the asset is still used in the natural resource business; (b) the property has been replaced with other natural resource property which is being used in the natural resource business; or (c) the property is subject to a taxable disposition. ORS 118.140(10)(a)–(c) (2011). The annual filing requirement ceases when the transferee completes five years of natural resource business use. ORS 118.140(10) (2011).

10. Natural Resource Tax Forms. The natural resource credit is claimed by filing Schedule NRC with the Oregon estate tax return. Any dispositions prior to the expiration of five out of eight years of qualified use following the death of the decedent are subject to tax, which is reported on Form IT-1A. It is expected that ODR will revise these forms and will create a new form to satisfy the annual reporting requirement.

III. THE OLD PRE-2012 OREGON INHERITANCE TAX

A. Calculating the Oregon Inheritance Tax—The Four Steps

These four steps do not appear in the Oregon inheritance tax statutes, but these steps must be followed in order to calculate the Oregon inheritance tax.

1. Calculate the gross estate, in order to determine if a return is required based on the filing threshold of $1,000,000. If no return is due, stop here.

2. Calculate the Oregon inheritance tax on the adjusted taxable estate using Table B in the IT-1 instructions. This rate table is the old federal state death tax credit rate table. *Do not apply a unified credit.* This step produces a tax even if the adjusted taxable estate is as small as $40,000.

3. Calculate the federal estate tax (using 2000 federal law) on the federal taxable estate (defined by 2000 federal law) using Table

A in the IT-1 instructions. *Include adjusted taxable gifts in the calculation.* Then apply a unified credit of $345,800 (unified credit equivalent of $1,000,000). The result of this step can be called the federal cap.

4. Pay the lesser of the two amounts shown in steps 2 and 3.

The number $1,093,784 is a magic number in the calculation of the Oregon inheritance tax. As noted above, estates pay Oregon inheritance tax in an amount equal to the lesser of the Oregon inheritance tax or the federal cap. Taxable estates below $1,093,784 pay an amount equal to the federal cap, while taxable estates above that amount pay a tax equal to the Oregon inheritance tax (the state death tax credit). As a result, taxable estates between $1,000,000 and $1,093,784 pay Oregon inheritance tax at a marginal rate of 41%, because the federal cap (and its federal estate tax rate table) is the limiting factor on the Oregon inheritance tax. Above $1,093,784, the marginal rate drops to 6.4% because the state death tax credit rate table is the limiting factor. That rate eventually climbs to 16% for very large estates. The significance of the number $1,093,784 is also discussed below, in the discussion of the impact of adjusted taxable gifts.

Although ORS 118.220 and OAR 150-118.100(1) provide that the Oregon inheritance tax is due and payable on the date that the federal estate tax is due, those provisions should not be interpreted as excusing the filing of an Oregon return (or the paying of the Oregon tax) for estates that owe no federal estate tax under current federal law. Because ORS 118.007 provides that Oregon is "frozen" to the federal estate tax as of December 31, 2000, ORS 118.220 and OAR 150-118.100(1) should be interpreted based on whether a federal estate tax would have been due under December 31, 2000, federal law. *Force v. Dept. of Revenue (Estate of Pierson),* 350 Or. 179, 252 P3d 206 (Or 2011). OAR 150-118.260(1)-(A) and OAR 150-118.100(1) confirm that the Oregon return is due nine months after the date of death. (In early 2011, the Oregon Department of Revenue announced that the automatic extension of time to file for 2010 deaths provided for in the federal Tax Relief Act of 2010 does not apply to Oregon returns.)

B. Lifetime Gifts

How do adjusted taxable gifts impact the pre-2012 Oregon inheritance tax? The answer is that adjusted taxable gifts are not taxed in the calculation of the Oregon inheritance tax, but they are taxed in the calculation of the federal cap. Here is a more detailed answer.

Adjusted taxable gifts are the cumulative amounts of gifts of the decedent that did not qualify for the annual exclusion, combined with the cumulative amounts by which qualifying gifts exceeded the annual exclusion. IRC §2001(b) and §2503. In order to determine the impact of adjusted taxable gifts on the Oregon inheritance tax, it is necessary to carefully analyze how the adjusted taxable gifts fit into the four-step process of calculating the Oregon inheritance tax.

(Note that IRC §2035(a), which purports to bring back into the federal gross estate certain gifts made within three years of death, is

usually not applicable. The 1976 federal change that abandoned the contemplation of death rule and enacted a three-year rule was itself largely abandoned in 1981, and §2035(a) now has very limited application. Section 2035(b) brings back into the gross estate gift taxes paid within three years of the decedent's death, but relatively few decedents have paid gift taxes.)

Before we work through the four steps, it will be helpful to discuss some of the terms defined above.

✦ **Gross Estate.** Oregon has adopted the federal definition of gross estate, so the gross estate will be the same for federal and Oregon purposes. ORS 118.005(5); IRC §2031. The gross estate does *not* include adjusted taxable gifts.

✦ **Adjusted Taxable Estate.** The adjusted taxable estate is equal to the taxable estate minus $60,000. IRC §2011(b)(3). None of the gross estate, the taxable estate, or the adjusted taxable estate includes adjusted taxable gifts. IRC §2001(b).

For simplicity of illustration, assume a 2009 death of an unmarried decedent with no deductions of any kind (no marital bequests, charitable bequests, claims, or administration expenses). We will ignore annual exclusions.

1. Step 1—Filing Threshold. The first step in calculating the Oregon inheritance tax is to determine whether the estate exceeds the Oregon filing threshold. The filing threshold is determined by the value of the gross estate. If the gross estate equals or exceeds $1,000,000, then an Oregon return is due, and the second, third, and fourth steps must then be analyzed. If the gross estate is less than $1,000,000, the filing threshold is not met, no return is due, and the other steps need not be examined. If no return is due, then no tax is due. ORS 118.160(1)(b)(D) (2009).

If a client dies with a gross estate of $1,100,000, an Oregon return is due, and the other steps (described below) will result in a tax. But if that client makes a gift of $150,000 immediately before her death, her gross estate will be $950,000, because the gross estate does not include adjusted taxable gifts. As a result, no return will be due, and no tax will be due. In both cases, her children will receive the entire estate. In the first example, they will pay an Oregon inheritance tax of $38,800, but in the second example, the estate will pass 100% tax-free. Yet in both examples the client started out with the same assets. By making a $150,000 gift, the client saved her family $38,800. (A decision whether to make such gifts should also take into account that lifetime gifts generally do not receive a stepped-up basis at death, while assets transferred at death do receive a stepped up basis.)

2. Step 2—Calculate the Oregon Inheritance Tax. If a return is due, the second step is to calculate the Oregon inheritance tax. The Oregon inheritance tax is based on the amount of the adjusted taxable estate. The adjusted taxable estate is equal to the taxable estate minus $60,000. IRC §2011(b)(3). The adjusted taxable estate does *not* include

taxable gifts. The amount of the Oregon tax is based on a rate table that is identical to the old federal table for the state death tax credit. ORS 118.010(2) (2009). That table appears as Table B in the instructions to the Form IT-1. *That rate table does not utilize a unified credit.* Instead, it generates a tax as soon as the adjusted taxable estate exceeds $40,000. In our example, if the gift had not been made, the estate of $1,100,000 would generate an Oregon inheritance tax of $38,800. But that amount is not necessarily the amount you pay. Instead, we must continue on to step 3.

3. Step 3—Calculate the Federal Cap. The third step is to calculate what we will call the federal cap. This is the federal estate tax the estate would have paid (in our example) for a 2009 death based on the federal law applicable to a 2009 death as that law existed in 2000. At that time, the federal unified credit equivalent was scheduled to be $1,000,000 for a 2009 death. Unlike the calculation of the Oregon inheritance tax, the calculation of the federal estate tax (and thus the federal cap) requires that any adjusted taxable gifts be added back in before the estate tax is calculated. IRC §2001(b). In our example of a $1,100,000 estate, the federal cap would be calculated on $1,100,000, regardless of whether or not our decedent had made the deathbed gift of $150,000.

The federal cap is calculated using the federal estate tax rate table that appears as Table A in the instructions to the Form IT-1. After the tax is calculated, the unified credit of $345,800 (which is the tax equivalent of assets worth $1,000,000) is applied. The result is the federal cap. In our illustration, the resulting federal cap would be $41,000.

4. Step 4—Amount of Tax to Pay. The amount of the Oregon inheritance tax is the lesser of the results of step 2 and step 3. Here's why: ORS 118.010(2) imposes a tax equal to the maximum allowable state death tax credit available for the year of death based on 2000 federal law. However, an estate can receive a credit only against tax it actually owes. The credit cannot exceed the tax. As a result, if the 2000 federal tax was less than the amount calculated by the state death tax credit table, then that lower amount of the tax limits the availability of the credit. The federal tax "caps" the credit. In our example of the $1,100,000 estate with no gift, the lesser of the two steps is $38,800. If the $150,000 gift had been made, the tax would have been zero, because no return would have been due.

After reviewing that analysis, we can answer our question: Does the Oregon inheritance tax apply to adjusted taxable gifts? The answer takes three forms.

1. If the decedent used adjusted taxable gifts to reduce her gross estate below the Oregon filing threshold, then the adjusted taxable gifts (and the rest of her estate) completely avoid the Oregon inheritance tax. ORS 118.160(1)(b)(D) (2009).

2. If her gross estate (after the gifts) is above the Oregon filing threshold, then a return will be due. Her adjusted taxable gifts will *not* be taken into account in calculating the Oregon inheritance tax (step 2), but those gifts will be taken into account in the calculation of the fed-

eral cap (step 3). In most cases, making adjusted taxable gifts will (with one minor exception) reduce the Oregon inheritance tax by the amount of the marginal rate of the state death tax credit applied to the adjusted taxable estate. For example, the tax savings resulting from a $10,000 taxable gift from a $1,100,000 estate would be $560, or 5.6% of the gift. If the estate were $3,000,000, the tax savings would be $880, or 8.8% of the gift.

3. The one minor exception: If the Oregon inheritance tax is greater than the federal cap, then the federal cap will be the determining factor because it is the lesser of the two. In that situation, making adjusted taxable gifts will not reduce the tax due because the federal cap includes a tax on the gifts. This exception occurs only if the taxable estate (excluding the gifts) is less than $1,093,784. Below this amount, the Oregon inheritance tax is greater than the federal cap, and the gifts will be taxed. But even this minor exception has an exception: If the taxable estate (excluding the gifts) is only slightly below $1,093,784, and the gifts are large enough to bring the Oregon inheritance tax below the federal cap, then tax savings can still be obtained.

Although the Oregon inheritance tax does not generally apply to adjusted taxable gifts, that is not to say that adjusted taxable gifts have no consequence in connection with the Oregon inheritance tax. For example, the presence of adjusted taxable gifts can significantly reduce the amount that can be placed in a credit shelter trust, even though no federal tax is due. Consider the following example: Decedent makes adjusted taxable gifts in the amount of $800,000, then dies in 2011 leaving a gross estate of $3,000,000, a surviving spouse, and a typical tax-planning will that calls for the creation of two trusts, a credit shelter trust and a marital trust, to be funded with the entire $3,000,000 gross estate. Both trusts are drafted so that they are eligible for a QTIP election, either federal or Oregon. The gross estate is well below the federal $5,120,000 unified credit, even if adjusted taxable gifts are included, so no federal return or federal tax is due. And no Oregon inheritance tax will be due, as a result of the marital deduction. But how much marital deduction is needed to reduce the Oregon inheritance tax to zero? And how large may the Oregon-exempt credit shelter trust be, assuming that the goal is to maximize the size of the Oregon-exempt trust in order to minimize the tax due on the second death? The answer is surprising: The estate will need to claim a $2,800,000 marital deduction by making an Oregon QTIP election on $2,800,000 of the trusts, and the Oregon-exempt trust will be limited to only $200,000. That result is caused by several factors. First, the calculation of the Oregon inheritance tax (Step 2) does not employ a unified credit or an exemption; it triggers Oregon tax at only $40,000. Second, the calculation of the federal cap (Step 3) takes into account the adjusted taxable gifts, which effectively means that the adjusted taxable gifts end up consuming some of the federal unified credit that was available under 2000 law. In our example, in order to reduce the Oregon inheritance tax to zero, either Step 2 or Step 3 needs to be reduced to zero, because the amount to be paid is the lesser of those two steps. In order to reduce Step 2 to zero, the marital deduction would have

to be $2,900,000 (the other $100,000 would be protected by the $40,000 Oregon "exemption" and by the $60,000 difference between the taxable estate and the adjusted taxable estate). In order to reduce Step 3 to zero, the marital deduction would have to be $2,800,000 in order to shelter $2,000,000 of the trusts and the $800,000 of adjusted taxable gifts, leaving $1,000,000 to be protected by the $1,000,000 unified credit available in 2011 under the 2000 law, since Step 3 is based on 2000 law. As a result, a marital deduction of $2,800,000 will need to be claimed (by making an Oregon QTIP election), and the size of the Oregon-exempt trust will be limited to only $200,000. (Of course, a different result might be desirable if it is decided to pay some tax in the first estate in order to reduce the tax payable in the second estate.)

If you plan to use the alternate valuation date election to eliminate an Oregon inheritance tax that would otherwise be due, and your client has made adjusted taxable gifts, the reduction in value attributable to the alternate valuation election must be large enough to reduce the federal cap to zero. In other words, the taxable estate plus the adjusted taxable gifts (the federal tax computation base) must be reduced to a point below $1,000,000 in order to reduce the federal cap to zero. Simply reducing the Oregon gross estate to a point below $1,000,000 is not sufficient. This is because the estate will pay the lesser of the federal cap (step 3) or the Oregon inheritance tax, which is based on the state death tax credit table (step 2). The state death tax credit table does not employ a unified credit. Instead, the tax is imposed on all amounts over $40,000. Unless the federal cap is zero, the estate will pay some Oregon tax. Because an Oregon return must be filed in order to make an Oregon alternate valuation date election, using the alternate valuation date to reduce the gross estate below $1,000,000 does not avoid the filing requirement. §2032(d); OAR 150-118.010(7)(1).

You could calculate some illustrations to determine the amount of tax savings that might be obtained by making various taxable gifts. It all depends on the size of the estate and the size of the gifts. As a general rule, the client will save the most money if the gifts reduce the gross estate to a point below the $1,000,000 Oregon filing threshold, but lesser tax savings are available even if the resulting gross estate is still above the filing threshold. Also, keep in mind that the tax savings described above are understated, because they do not take into account the annual exclusion.

C. Residents vs. Nonresidents

Prior to 2012, Oregon taxed resident decedents on (1) tangible personal property located in Oregon, (2) real property located in Oregon, and (3) all intangible property regardless of situs. *But the inheritance tax is calculated on the entire taxable estate (wherever located), and then the tax is multiplied by a fraction,* the numerator of which is the sum of the three classifications described above, and the denominator is the entire gross estate. ORS 118.010(3).

Nonresident decedents are taxed on property located in Oregon, including tangible personal property and real property. Nonresidents are also taxed on intangibles located in Oregon, unless the state of domicile grants reciprocity (an exemption for intangibles owned by nonresident decedents). *But the tax is calculated on the entire taxable estate (wherever located), and then the tax is multiplied by a fraction,* the numerator of which is the value of the assets subject to tax in Oregon, and the denominator is the entire gross estate. ORS 118.010(4). The definition of intangibles located in Oregon appears to be very broad, at least according to the regulations. OAR 150-118.010(1)(2) and (3).

In short, under the Oregon statutory scheme tangible property (both real and personal) will be taxed only by the state in which it is located, in both resident and nonresident estates. Intangible personal property held by resident estates will be taxed regardless of location, and intangible personal property held by nonresident estates will be taxed only if it is located in Oregon and the resident state does not grant a reciprocal exemption. ORS 118.010; OAR 150-118.010(3) and (4).

These statutes can produce some unexpected results. As noted above, the filing threshold of $1,000,000 is based on the gross estate, regardless of where the assets of the gross estate are located. ORS 118.160(1)(b)(D). As a result, a nonresident with a gross estate of $1,000,000 or more, but with a small amount of Oregon assets, will be required to file an Oregon inheritance tax return and will be required to pay Oregon inheritance tax if the taxable estate exceeds $1,000,000, even if the state of residence imposes no estate or inheritance tax.

For example, if an Oregon resident moves to California (which has no estate or inheritance tax) but leaves behind in Oregon either real property, tangible personal property, or (more likely) intangible personal property (such as an Oregon bank account), that person's estate will be subject to Oregon inheritance tax if the taxable estate (wherever located) exceeds $1,000,000. The same result will take place if the person never lived in Oregon but happens to own real or personal (tangible or intangible) property in Oregon. *Because of the fractional method of calculating the tax, even a small amount of Oregon property will trigger a tax. And the definition of intangible personal property is extremely broad, at least according to the regulations.* OAR 150-118.010(1)(2) and (3).

The same result will take place if the person lived in Washington, except Washington has its own estate tax, and Oregon exempts the intangible personal property of Washington residents because Washington grants a reciprocal exemption for intangible personal property of Oregon residents. RCW 83.100.040; WAC Ch. 458-57-125. As a result, an Oregon tax will be due from a Washington resident estate if the estate holds Oregon real property or tangible personal property located in Oregon, even if the value of the Oregon property is small.

A reciprocal exemption for intangible property does not exist between Oregon and California. California has no estate or inheritance tax, and the Oregon regulations provide that the exemption exists in Oregon only if the foreign state imposes an estate or inheritance tax *and*

exempts the intangible personal property of Oregon residents. OAR 150-118.010(4)(b); California Revenue and Taxation Code §13302.

If all of the Oregon property of a nonresident passes to a surviving spouse or to a charity, the Oregon inheritance tax on nonresidents is not necessarily eliminated. Marital deductions and charitable deductions, like all other deductions, reduce the taxable estate, not the gross estate, and the fractional formula employs the gross estate as its denominator and the gross estate located in Oregon as its numerator. The fact that some or all of the numerator passes to a spouse or a charity does not affect the fraction or the resulting percentage. Marital deductions and charitable deductions will reduce the overall Oregon tax, but they will not reduce the percentage of the tax payable to Oregon, nor will they reduce the assets (the gross estate) to be measured against the filing threshold. As a result, the amount of tax payable to Oregon will remain the same regardless of whether Oregon assets or foreign assets pass to the spouse or to charity (assuming that the value passing to the spouse or to charity remains the same).

The same result occurs if the Oregon property is subject to an encumbrance. The encumbrance reduces the taxable estate, but it does not reduce the amount of the gross estate in Oregon, nor does it reduce the gross estate located elsewhere. Thus, it is possible to owe Oregon inheritance tax on a nonresident estate even when the net value of the Oregon assets is negative due to an encumbrance on the Oregon assets.

As mentioned above, the Oregon Department of Revenue has adopted a very broad definition of intangible personal property located in Oregon. The statute variously refers to such property as "within the jurisdiction of the state" or "located in Oregon." ORS 118.010(1) and (4). The regulations adopt the position that property within the jurisdiction of the state includes (for example) stock in an Oregon corporation, accounts in Oregon banks, and promissory notes given by an Oregon resident. The regulations also define "intangible personal property" as including "stocks, bonds, notes, currency, bank deposits, accounts receivable, patents, trademarks, copyrights, royalties, goodwill, partnership interests, life insurance policies, and other choices (sic) in action." OAR 150-118.010(1)(3).

The ambiguous drafting of the statute and the regulations raises many questions. Why do ORS 118.010(1) and ORS 118.010(4)(a) both refer to "property within the jurisdiction of the state," while the fractional formula in ORS 118.010(4)(a) includes only property "located in Oregon," particularly when the regulations at OAR 150-118.010(1)(2) specifically state that "within the jurisdiction of the state" is broader than "'within the state' which denotes locality"? And it seems hard to believe that a court would allow Oregon to tax stock in an Oregon publicly traded corporation held by the estate of a nonresident, as suggested by OAR 150-118.010(1)(2)(a).

Equally puzzling is the fact that the legislature drafted the statute in a manner that reflects a determination by the legislature that personal property of a nonresident can have a situs in Oregon. Yet the Oregon

Court of Appeals has held in a probate case that the personal property of a nonresident decedent has the same situs as the decedent's domicile. *West v. White*, 92 Or. App. 401 (1988). Although the *West* case dealt with an intangible (a promissory note), the holding is not limited to intangible personal property.

Keep in mind, however, that no Oregon inheritance tax return will be due (and no tax will be due) if the worldwide gross estate of the decedent is less than the filing threshold of $1,000,000. ORS 118.160(1)(b)(D).

The bottom line: nonresident clients with even a small amount of Oregon assets should review their situation in order to determine whether steps should be taken to minimize or eliminate the Oregon inheritance tax. Those steps might include disposing of Oregon assets or moving the Oregon assets to another state, such as the state of residence, depending on the inheritance tax laws of the state of residence. Even Oregon residents can reduce their Oregon inheritance tax by holding tangible assets in other states, but the amount of overall tax savings will depend on the inheritance tax laws of those other states.

IV. PROCEDURES APPLICABLE TO BOTH OLD AND NEW LAW

A. Requesting an Oregon Release

HB 2308 (2009 Oregon Laws Ch. 358) now permits personal representatives and trustees to make a written request to the Department of Revenue for a prompt determination of the Oregon inheritance tax and a release from the fiduciary's personal liability for the tax. This new provision has been codified as ORS 118.265. (This ability to request a release from personal liability from estate tax is somewhat similar to the federal statute, §2204(a).) Upon receipt of such an application, the department is required to notify the fiduciary of the amount of tax due. That notice of tax due is required to be given "as soon as possible, and in any event within 18 months of the application." After the payment of any tax specified in the notice, the fiduciary "shall be" discharged from personal liability, and the department will send the fiduciary a receipt or release to that effect. Administrative rules will be adopted to describe this procedure in more detail, and a request form was published on January 1, 2010. See Form 150-103-005 on the Department website. A special version of the 18-month rule is provided in the legislation in the unusual circumstance that an estate makes a request for a release before the return is filed. See HB 2308, section 2(1).

This new procedure became effective on January 1, 2010, but it is not limited to returns filed after that date. As a result, any estate may file a request for release on or after January 1, 2010, including estates that have filed returns previously. Requests filed prior to that date will not be effective, because the new statute does not authorize requests made prior to that date.

The ability to request a release for a previously filed return presents an issue brought about by the recent Oregon tax amnesty program (which runs from October 1, 2009, to November 19, 2009). Under that

program (SB 880; 2009 Oregon Laws Ch. 710), an estate can apply for "amnesty" and then file a past-due return or an amended return and pay past-due taxes for an inheritance tax return originally due before January 1, 2008. If certain other conditions are met, the Department of Revenue will waive all penalties and half of the interest that would otherwise apply. However, as an "incentive" for taxpayers to participate in the amnesty program, if a taxpayer decides to not participate in the program (or was simply unaware of the program) but later is found to owe tax on a return that would have been eligible for the amnesty program, then that taxpayer will be subject to an additional penalty of 25% of the tax due, in addition to all of the previously due penalties and interest, with no reduction under the amnesty program. For example, if in 2010 an estate requests a release for an inheritance tax return originally timely filed in 2007, and that request for release causes the department to review the return, and the department determines that additional tax is due, the department could assert an additional 25% penalty for failure to have participated in the amnesty program. As a result, estates may wish to review their situation carefully before requesting a release for returns due before January 1, 2008. Those estates may prefer to simply allow the statute of limitations to expire. See below regarding the new Oregon statute of limitations on the collection of inheritance tax.

This legislation does not repeal ORS 118.250, which requires that the Oregon Department of Revenue issue receipts for inheritance tax paid. As a result, the department presumably will continue to issue the same receipts that it has been issuing for the last several years.

It is important to note what this statute does not do. Although it releases the personal representative from personal liability, it does not release the beneficiaries. If the fiduciary is also a beneficiary, that person's potential liability *as beneficiary* will continue. Although the statute does not so state, the Request for Discharge form published by the Department indicates that the discharge is not effective to the extent that the fiduciary remains in possession or control of estate assets. Beneficiaries remain liable to the extent of assets received by them (ORS 118.270), and the statute of limitations on collecting tax from them is not limited by this new statute. As a practical matter, however, a release of the fiduciary will likely serve as an indication that the Department of Revenue has examined the return and does not intend to seek any additional taxes. But it might possibly (although unlikely) mean that the Department feels it will be able to collect any additional tax from the beneficiaries. And fiduciaries remain responsible to notify the Department of Revenue within 90 days in the event of a change in the federal tax liability, either through an audit or an amended return. See ORS 118.100 and page 2 of the Form IT-1 instructions. The 90-day period is not statutory, nor does it appear in the regulations; it appears only in the IT-1 instructions.

B. Extensions

Extensions of the time to file and the time to pay are both available regarding the Oregon inheritance tax. If a federal extension is re-

quested on IRS Form 4768, a copy of that form should be filed with the Oregon return, when it is filed, and the appropriate boxes should be checked on page 1 of the Oregon return. If no federal return is being filed, or if a federal extension is not being requested, the same Form 4768 should be used, but the words "For Oregon Only" should be typed in the top margin of the form, and the form should be filed with the Department of Revenue prior to the due date. OAR 150-118.225(1)(a). A copy should also be attached to the return when it is filed. A six-month extension of time to file is automatic, but a request for extension of time to pay requires an explanation of why the extension is needed, and the department will respond with either an approval or a rejection. Oregon follows federal law in reviewing such requests. See ORS 118.225 and OAR 150-118.225(2)(a).

An extension of time to file does not extend the time to pay, nor does an extension of time to pay extend the time to file. Interest continues to accrue during the extension period. OAR 150-118.225(1)(b); 150-118.260(1)-(B).

If all or part of the Oregon estate tax cannot be paid within nine months after the date of death, the executor may apply for an extension of the time to pay the tax. If the executor secures the payment of the tax with a bond, deposit, or other good collateral acceptable to the Department of Revenue, the department may extend the time for the payment of the tax up to 14 years. ORS 118.160. However, under the old law, even though the executor obtained permission from the department to extend the time for payment and paid the tax in the agreed installments, the tier 2 penalty interest (currently 4%) under ORS 305.222 was added to the delinquency rate of 5% for a total of 9% starting 60 days after the tax was assessed. The Oregon interest rate of 9% currently is significantly higher that the interest rate payable under an installment plan under IRC 6166. The new law drops the tier-2 interest rate under ORS 305.222 but retains the delinquency rate under ORS 305.220. Thus, under the current rates, an installment plan approved by the department will impose a 5% interest rate. ORS 118.160(5) (2011).

C. Interest and Penalties

Interest on Oregon taxes accrues from the original due date of the return, which is nine months after the date of death. ORS 118.220; 118.260(5)(a); 314.400(7); OAR 150-118.260(4). Although ORS 305.220 specifies an interest rate, that rate is adjusted occasionally, and the latest rate can be found at OAR 150-305.220. The statute refers to simple interest, not compound interest. Although ORS 305.220(1) and (2) call for a rate of interest per month or fraction thereof, a daily rate is used for fractional months. ORS 305.220(6); OAR 150-118.260(4). For interest covering periods of time during which the interest rate changed, the interest must be computed at the rates in effect during those time periods. The historic tables are not in the OARs, but they can be found at http://www.oregon.gov/DOR/docs/IncomeR/Chapter305.pdf.

If payment of the tax has been extended under ORS 118.220, the interest nevertheless accrues from the original due date of the return. ORS 118.260(5)(b); OAR 150-118.225(1)(b); 150-118.260(1)-(B). If the tax has not yet been calculated, a deposit may be made to stop the running of interest and penalties on the portion of the tax deposited. ORS 118.260(7) and (9); OAR 150-118.260(1)-(A). Payments are credited first to penalties and interest and then to the tax itself. ORS 118.260(8).

If inheritance tax is not paid within 60 days after notice of a tax delinquency, the interest rate imposed by ORS 305.220 is increased by one-third of 1% per month (4% annually). Such notices include a notice of assessment following a deficiency or a final order issued by the Tax Court or Supreme Court that affirms the deficiency. OAR 150-305.222(1). The department reportedly has taken the position that that enhanced interest rate applies to §6166 installment payments, even if all of the installment payments are made by their respective due dates.

ORS 118.260(1) imposes a 5% "delinquency penalty" for a late return, plus ORS 118.260(2) imposes an additional 20% "failure to file penalty" if the return is more than three months late. Thus a return more than three months late would be required to pay a total penalty of 25%. If any of the delinquency is due to fraud with intent to avoid tax, then a penalty of 100% is applied pursuant to ORS 118.260(3), although this particular subsection is ambiguous as to whether it is referring to a penalty or simply the tax itself. (Similar penalties appear in ORS 314.400, but that statute is apparently limited to income taxes, while ORS 118.260 applies to inheritance taxes.) See also OAR 150-118.260(1)-(A) and (B).

ORS 305.992 purports to impose a 100% penalty if tax returns are not filed for three consecutive years. An administrative rule, OAR 150-305.992, confirms that that statute is intended to apply to annual returns. However, the statute itself makes reference to ORS Chapter 118, which is the inheritance tax statute, even though the inheritance tax return is not an annual return. As a result, the Oregon Department of Revenue might contend that an inheritance tax return more than three years late will be subject to a 125% penalty, even if no fraud is involved. ORS 305.992 also states that the 100% penalty is in addition to any other penalties. Although that statute also states that the total penalties may not exceed 100%, the "total penalties" described in that statute do not include the penalties imposed by ORS Chapter 118.

Under the new Oregon estate tax, interest on refunds owing to an estate will begin to accrue 45 days after a refund claim is filed. ORS 118.100(1), ORS 314.415, and ORS 118.260(7) (2011).

D. Statute of Limitations

For deaths prior to 2012, the 2009 legislative session enacted HB 2308 (2009 Oregon Laws Ch. 358) to correct a flaw in prior Oregon law, which inadvertently did not impose any statute of limitations on the collection of inheritance tax by the Department of Revenue or on the claiming of refunds by estates. This new statute imposes a three-year statute of limitations on deficiencies. It does so by adopting the three-

year income tax statute of limitations on deficiencies, which is ORS 314.410. That new statute of limitations on deficiencies has been codified as ORS 118.227 and 118.265. With regard to refunds, the new statute adopts the income tax statute on refunds, ORS 314.415, which imposes a period equal to the later of three years from when the return was filed or two years from when tax was paid, whichever is later, within which to file a refund claim. That new statute of limitations on refunds has been codified as ORS 118.227. These statutes are similar to the corresponding federal statutes. Although the Oregon income tax deficiency statute extends the period to five years if 25% or more of gross income was omitted from the return, and the federal estate tax statute extends to six years the statutory period if the estate omitted more than 25% of its assets, the 2009 inheritance tax statute makes no mention of a 25% omission from the gross estate, so presumably the extended five-year period (or six-year period) does not apply to the inheritance tax. This new law became effective on September 28, 2009 (91 days after the legislature adjourned on June 29, 2009). It appears to apply to all inheritance tax returns, including those filed in the past.

For deaths after 2011, the new Oregon estate tax includes new statute of limitations provisions that were codified at ORS 118.165. HB 2541, §28 (2011); 2011 Oregon Laws ch. 526, §28. That statute now includes a regular three-year period, a five-year period for returns that have omitted more than 25% of the gross estate, and an unlimited period for false or fraudulent returns. In other words, under the new law the Department of Revenue may issue a notice of deficiency pursuant to ORS 305.265 within three years after an estate tax return is filed. If the gross estate has been undervalued by greater than 25%, the notice may be issued within five years after the estate tax return is filed. If no return is filed, or if the return is false or fraudulent, the notice may be issued at any time.

Under both old law and new law, the statute of limitations on deficiencies does not begin running until a return is filed.

E. Availability of Federal Elections

ORS 118.010(7) (changed to (8) in 2011) and OAR 150-118.010(7) allow estates to make for Oregon purposes all of the elections permitted under federal law. Oregon allows separate elections to be made for Oregon purposes, regardless of whether a federal return is filed.

Under the old Oregon inheritance tax, although separate elections could be made for Oregon purposes, if a federal election was made, then the same election was binding for Oregon purposes, unless a specific Oregon statute or administrative rule permitted different elections to be made on the two returns. OAR 150-118.140(2). The only Oregon rule or statute that specifically provided otherwise is OAR 150-118.010(2), which permitted inconsistent elections under §642(g), which is the election to take administration expense deductions on the fiduciary income tax return or on the estate tax return.

Under the new Oregon estate tax, separate inconsistent elections may now be made for federal and Oregon purposes. ORS 118.010(8) (2011).

ORS 118.010(8)(c) (2011) now provides that elections are irrevocable. That same requirement previously appeared in OAR 150-118.010(7)(1).

Although OAR 150-118.010(7) permits separate Oregon elections for all available federal elections regardless of whether a federal return is filed, that rule does not appear to address contrary (inconsistent) federal and Oregon elections. Thus, OAR 150-118.140(2) and OAR 150-118.010(7), read together, appear to require that if a federal election is made, the same Oregon election must also be made, but if a particular election is not made on the federal return, or if no federal return is filed, that election can nevertheless be made on the Oregon return. That interpretation seems to be the one held by most practitioners who have studied this issue. However, it is also possible to read OAR 150-118.140(2) and OAR 150-118.010(7) as being entirely inconsistent, such that one permits different (inconsistent) elections for federal and Oregon purposes, while the other requires that the elections be exactly the same. As a result, it is possible that the department will require that if federal and state returns are both filed, the same elections must be made on both returns.

OAR 150-118.010(7)(3) provides that when an Oregon election is made, the obligations of the electing parties, agreements required of persons benefitting from the elections, and the inclusions of property in the estate of a surviving spouse shall apply for Oregon purposes just as they would have applied under the 2000 Internal Revenue Code for federal purposes. In other words, Oregon has adopted all of the federal procedural requirements existing under 2000 federal law pertaining to federal elections.

If a separate election is being made, check the box to that effect in Part 1 on page 1 of the Form IT-1.

The elections permitted for Oregon purposes include the following.

✦ Section 2031(c)—Qualified Conservation Easements. ORS 118.010(8) (2011).

✦ Section 2032—Alternate Valuation Date. ORS 118.010(8) (2011) This election is discussed in greater detail below.

✦ Section 2032A—Special Use Property. ORS 118.010(8) (2011).

✦ Section 2033A—Qualified Family-Owned Business Interests. This election has been repealed for federal purposes, but because it was in effect on December 31, 2000, it is still available for Oregon purposes for deaths prior to 2012. See ORS 118.120 and both the 2009 and the 2011 versions of ORS 118.007.

✦ Section 2056—Qualified Terminable Interest Property (QTIPs). ORS 118.010(8) (2011).

✦ Section 2056A—Qualified Domestic Trusts (QDOTs). ORS 118.010(8) (2011).

Although this list of elections appears in OAR 150-118.010(7), that regulation makes it clear that the list is not exclusive, and any other election available under federal law is also available for Oregon purposes. All of the elections are irrevocable and must be made in the manner required by federal law, and that manner must be followed on the Oregon return even if a federal return is not required. ORS 118.010(8)(c) (2011); OAR 150-118.010(7)(1).

Other elections, not mentioned in OAR 150-118.010(7) or ORS 118.010(8) (2011), that are available for Oregon purposes include the following.

✦ Section 642(g)—election to take administration expense deductions on the fiduciary income tax return or on the Oregon inheritance tax return. OAR 150-118.010(2) specifically allows different §642(g) elections to be made on the federal and Oregon returns.

✦ Section 6166—Extension of time to pay estate tax on closely held businesses. See ORS 118.225.

✦ Section 6163—Extension of time to pay tax on value of reversionary or remainder interests.

✦ Section 6081 and §6161—Extensions of time to pay and/or file return. See the discussion of extensions, above.

Most of these elections are discussed on the Form IT-1 (now OR706) and in the instructions to that form.

F. The Oregon Alternate Valuation Date Election

Like other federal elections, the alternate valuation date election is available for Oregon purposes. ORS 118.010(8) (2011); OAR 150-118.010(7). Under federal law, the election may be made on a timely filed federal return, or it may be made on a federal return filed up to one year after its due date, including extensions. §2032(d). Oregon has adopted those federal procedural requirements. As a result, if an Oregon alternate valuation election is desired, an Oregon return must be filed and the election must be made on that return, even if the election causes the gross estate to fall below the filing threshold, and that return must be filed no later than one year after the due date, even if it is a no-tax-due return. OAR 150-118.010(7)(1). See also pages 9–10 of the IT-1 instructions.

If the alternate valuation date election is made for Oregon purposes but not made for federal purposes, then the estate and its beneficiaries will have a different federal basis in the assets than their Oregon basis in the assets. ORS 316.716. Keep in mind that a federal alternate valuation date election cannot be made if the election would not reduce federal taxes. §2032(c). Thus an estate that owes Oregon taxes, but owes no federal taxes, cannot make a federal alternate valuation date election but may make an Oregon election. In addition, as discussed above, if a federal alternate valuation date election is made, the same election must be made for Oregon purposes. OAR 150-118.140(2).

G. Appraisals

ORS 118.100(6) (2011) now requires that an estate tax return must "explain, on the return, how the reported values were determined." The executor must also "attach copies of any appraisals." Apparently, this latter provision does not require the executor to obtain an appraisal, but if one is obtained, a copy must be attached.

This new statute apparently reflects the reluctance of the Department of Revenue to accept county property tax values as evidence of fair market value, because the department believes that the county values do not generally represent the fair market value as of the date of death.

H. Apportionment of the Oregon Inheritance Tax

Apportionment of the Oregon inheritance/estate tax (and the federal estate tax) is governed by ORS 116.303 et seq. The tax is apportioned among the "persons interested in the estate," not among the bequests generated by the estate. ORS 116.313. The apportionment process includes nonprobate dispositions, because ORS 116.303(3) defines a "person interested in the estate" as any person who has received property from the decedent or received property by reason of the death of the decedent, if the property is included in the "estate," which is defined as the gross estate as determined for estate or inheritance tax purposes. ORS 116.303(1).

Marital and charitable bequests generally do not bear any apportionment of the tax. ORS 116.343(1) and (2). Those two types of bequests are discussed in that statute as deductions "allowed by reason of a relationship" and deductions "allowed by reason of the purpose of the gift."

In the event of a dispute over the apportionment of the tax, the probate court has jurisdiction to resolve the dispute, usually in connection with a petition for approval of a final accounting, but a separate petition on the subject of apportionment is permitted. ORS 116.323.

I. Federal Estate Tax Audits

ORS 118.100(2) requires fiduciaries to report to the Oregon Department of Revenue if a federal estate tax audit results in a change to the estate tax or if an amended federal estate tax return is filed with the IRS. The statute calls for a report, not an amended return.

J. The Oregon Special Marital Deduction and Schedule OSMP

In the classic estate plan for a married couple, the estate of the first spouse to die is divided into a credit shelter trust equal to the federal estate tax exemption, and the remainder of the estate is given to the surviving spouse, either outright or in a QTIP or other trust that qualifies for the marital deduction. The assets distributed to the credit shelter trust are shielded from tax by the federal estate tax exemption and the state inheritance tax exemption, and the assets given to the surviving spouse are shielded from tax by the marital deduction, at least at the first death. The beauty of this plan is that it uses both spouses' exemption amounts and produces no tax at the first death. This plan worked well for Oregon residents until 2002, when Oregon broke from the federal

estate tax system. Following the break, the federal exemption amount climbed from $1 million in 2002 to $3.5 million in 2009, was unlimited in 2010, and then was $5 million in 2011 and $5,120,000 in 2012. (The federal exemption after 2012 was not known as of this writing.) The Oregon exemption amount, however, stayed at $1 million for deaths after 2005. If the classic estate plan for a married couple were followed today, and the credit shelter trust were funded to the full amount of the federal exemption, the estate of the first to die would owe Oregon tax on the value of the credit shelter trust in excess of the $1 million Oregon exemption.

Under the new system, to avoid tax at the first death an estate had two choices. The first solution was to limit the credit shelter trust to $1 million, but there were obvious problems with this solution. Most of the existing marital funding formulas are tied to the federal exemption and therefore, by their terms, would not allow funding only up to the Oregon exemption amount. Also, the reduced funding would fail to use the full federal exemption amount for the deceased spouse. The second solution was to make an Oregon QTIP election for the assets in the credit shelter trust in excess of $1 million and thereby defer the Oregon tax until the later death of the surviving spouse. This solution would work well for many, but not all, estates. Although the terms of many credit shelter trusts qualify for a QTIP election, some do not. For example, in some credit shelter trusts the surviving spouse is not entitled to all of the income (accumulation trust), and in some trusts the surviving spouse is not the only trust beneficiary during the surviving spouse's lifetime (trust with other beneficiaries). Either of those facts would disqualify a trust for QTIP treatment.

To help solve the problems caused by the difference between the federal and Oregon exemption amounts, and to deal with the fact that some credit shelter trusts do not qualify for a QTIP election, in 2005 the Oregon legislature enacted an Oregon special marital election. ORS 118.013-019. The Oregon special marital property election (OSMP election) is an irrevocable election that allows a QTIP-like deferral for trusts (or other property interests, or a portion of a trust or other property) that would not otherwise qualify for an Oregon QTIP election. For example, trusts that permit income to be accumulated, and trusts that permit distributions to beneficiaries other than the surviving spouse, do not quality as QTIP trusts. Credit shelter trusts frequently contain such provisions. Under the OSMP election, both an accumulation trust and a trust with other beneficiaries are allowed to defer inheritance tax until the death of the surviving spouse. ORS 118.013(2) and (3); ORS 118.019 (2009). By using an OSMP election (or an Oregon QTIP election) for the portion of the credit shelter trust that exceeds $1 million, an estate can fund the credit shelter trust to the full federal exemption amount and still pay no Oregon tax at the first death. On the second death, the OSMP assets will be included in the gross estate of the surviving spouse, valued as of the date of death of the surviving spouse. ORS 118.019 (2009).

The OSMP election for an accumulation trust is made by the executor attaching a statement to the inheritance tax return that: (1) identi-

fies the trust (or other property interest) that constitutes the OSMP, (2) affirms that the identified property meets the requirements of OSMP, and (3) affirms that the trust will be administered as required by the statute. ORS 118.016(1).

The OSMP election for a trust that has other (nonspouse) beneficiaries allows the executor to set aside a portion of the trust as a separate share (or as a separate trust) as Oregon special marital property. ORS 118.013(3). In addition to the election described above for an accumulation trust, the surviving spouse and each potential beneficiary who is living at the time of the election must sign a notarized statement in which they: (1) consent to a portion of the trust (usually the amount in excess of $1,000,000) being set aside as OSMP, (2) agree to release all rights to distributions from the OSMP property during the surviving spouse's lifetime (except distributions to the spouse are permitted), and (3) agree that all other provisions of the trust will remain in effect. ORS 118.016(2). The statute provides language to be used when obtaining these consents. The statutory language is contained in Schedule OSMP.

The OSMP election is made on Schedule M and Schedule OSMP, which identify OSMP assets (and contain statements to be signed by the spouse and nonspouse beneficiaries when an OSMP election is made for a trust that has nonspouse beneficiaries). If a federal return is filed, the differences between the Oregon and federal marital deduction amounts must be explained. This can be done by filing an additional Schedule M marked "For Oregon Purposes Only" that identifies the OSMP assets. Although it may seem obvious that an executor is making an OSMP election if the estate files a Schedule OSMP, the schedule does not contain the statutorily required statements that affirm that the identified property meets the requirements of OSMP and that the trust will be administered as required by ORS 118.016(1). Out of an abundance of caution, an executor might consider attaching an exhibit to the Schedule OSMP that contains those two statements.

Schedule OSMP and the related instructions state that each asset subject to the OSMP election must be described in detail and identified by the Form 706 schedule and item number of the asset shown on the Oregon inheritance tax return. The instructions also state that unless the executor specifically identifies "a fractional portion of the trust or other property as not subject to the election, the election will be considered made for all of the trust or other property."

The requirement to specifically identify OSMP assets when the Oregon return is filed means that the credit shelter trust and the OSMP portion of that trust must be funded (or at least the assets chosen) before the IT-1 is filed (unless the OSMP property will remain a nonsegregated percentage portion of the federal credit shelter trust). However, this creates a problem for some estates that prefer to wait until receipt of the federal estate tax closing letter (when the date-of-death values of the decedent's assets will become fixed) before actually funding the federal credit shelter trust and also funding the OSMP trust. The problem is compounded if the estate intends to carve out a separate share of the

federal credit shelter trust to hold in a segregated account labeled as assets subject to the OSMP election, rather than simply designating a percentage of the credit shelter trust as OSMP assets.

Until recently, the Oregon Department of Revenue has been permitting estates to specify a fractional formula on the Schedule OSMP (the form even refers to a fractional portion) and then wait until receipt of the federal estate tax closing letter before actually funding the federal credit shelter trust and also funding the segregated OSMP trust. In that situation, no specific assets would be specified on the Oregon-only Schedule M or on the Schedule OSMP. Under those circumstances, the Schedule OSMP would specify a fractional formula and further state that an amended return will be filed when the segregated OSMP trust is funded.

However, the Department of Revenue has been reviewing that policy due to the passage of House Bill 2308 (2009 Oregon Laws Chapter 358), which authorizes estates to request a release of the personal representative from personal liability for the Oregon inheritance tax. Pursuant to that legislation, if such a release is requested by an estate it must be issued by the department within 18 months following the request. (HB 2308 is discussed above.) The department now believes that a request for release under HB 2308 (and its 18-month release period) may interfere with the filing of an amended return or might interfere with the department's review of such an amended return. As a result, the department is backing away from its prior policy of allowing estates to file amended returns to satisfy the identification requirement of ORS 118.016(1)(a). As a result of this development, it may be that all estates will be required to specifically identify their OSMP property on the original return (rather than specifying a fractional share), and thus the funding of a segregated OSMP trust (or at least the selection of its assets) may be required prior to filing the IT-1. If the OSMP trust will not be segregated from the credit shelter trust, then a percentage of the credit shelter trust may be identified on the original Schedule OSMP.

The 2011 legislation deleted references to "beneficiaries" in the OSMP statute and instead inserted references to "permissible distributees," as that term is defined in ORS 130.010 of the Oregon version of the Uniform Trust Code. Since the OSMP statute does not specifically define beneficiaries, the term was changed to permissible distributes in order to more precisely define and identify the beneficiaries who must consent to the OSMP election.

K. The Oregon QTIP Election

ORS 118.010(7) (2009) and OAR 150-118.010(7) allow estates to make for Oregon purposes all of the elections permitted under federal law, as the federal law existed on December 31, 2000. The availability of an Oregon QTIP election is specifically mentioned in ORS 118.010(8) (2011) and OAR 150-118.010(7). An Oregon QTIP election is made by filing an Oregon-only Schedule M that specifically identifies the property subject to the Oregon-only QTIP election.

OAR 150-118.010(7)(3) provides that when an Oregon election is made, the obligations of the electing parties, agreements required of persons benefitting from the elections, and inclusions of property in the estate of a surviving spouse shall apply for Oregon purposes just as they would have applied under the 2000 Internal Revenue Code for federal purposes. As a result, all of the other federal requirements for QTIP elections and QTIP property apply for Oregon purposes.

When would an executor prefer to make an Oregon QTIP election rather than an Oregon OSMP election? Obviously, if the trust interest would not qualify as a QTIP but would qualify as an OSMP, then the OSMP election should be made. But if the trust interest qualifies as both a QTIP interest and an OSMP interest, either election could be made, and there seems to be little reason to prefer one over the other. The QTIP election is governed by federal law and is not subject to the identification requirement of ORS 118.016 or Schedule OSMP, so it may seem that the QTIP election might be easier and simpler to make. However, the instructions to the Form IT-1 do require identification of specific assets that will be subject to the QTIP election. Making a QTIP election would, however, eliminate the requirement of filing a Schedule OSMP.

Some practitioners believe that a trust that qualifies as a QTIP trust is eligible only for a QTIP election and that such a trust may not be subject to an OMSP election. In other words, the OSMP election is limited to trusts that do not qualify for a QTIP election.

L. Qualified Family-Owned Business Interest Deduction

Under the old law, which tied to the IRC as of December 31, 2000, an estate could claim a qualified family-owned business interest ("QFOBI") deduction pursuant to the provisions of IRC 2057. By using this deduction plus the $1 million exemption, an estate could increase its effective exemption amount to $1.3 million. This deduction was repealed at the federal level in 2004 as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"); however, it remains in effect for Oregon estates through 2011. Since the new law changed the IRC tie-in date to December 31, 2010, the QFOBI deduction is effectively repealed beginning in 2012. However, if the provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 sunset in 2013, the QFOBI deduction will return.

M. Qualified Tax Disclaimers

The Oregon taxable disclaimer statute (ORS 105.645) was amended to change the Internal Revenue Code reference date to December 31, 2010, and this change is effective retroactive to January 1, 2010, in order to accommodate the extension of the time for making a tax qualified disclaimer in connection with a 2010 estate, which was provided in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Chapter 6

QUALIFIED PERSONAL RESIDENCE TRUSTS—COMMON SITUATIONS AND OPTIONS

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I. INTRODUCTION

Qualified personal residence trusts (as defined in II.A.) have been a commonly employed estate planning tool for over twenty years. During those two decades, qualified personal residence trusts have evolved from a "cutting edge" strategy to a fairly ordinary strategy. The use of qualified personal residence trusts has been informed over time, and the purpose of this outline is to provide a framework for working through common issues that arise during their administration.

II. QUALIFIED PERSONAL RESIDENCE TRUSTS—GENERAL OVERVIEW

A. Definition of Qualified Personal Residence Trust

A qualified personal residence trust ("QPRT") is an irrevocable trust that complies with the requirements of Reg. § 25.2702-5(c). A QPRT must hold no assets other than an interest in one personal residence property and certain related assets (such as proceeds from a sale of that property). A QPRT is created for a specific period of time (the "initial QPRT term"), during which the interest in the personal residence used to fund the QPRT must be used by the donor as his or her personal residence or held for his or her use as a personal residence. Reg. § 25.2702-5(c)(7)(i). There may be a secondary term following the expiration of the initial QPRT term.

B. Strategy

When an individual donor funds a QPRT, the individual makes a gift (typically to children or to a follow on trust for the benefit of children) at a discounted value for federal gift tax purposes. Because neither Oregon nor Washington has a state gift tax, there is no state gift tax consideration for clients and practitioners in either state. If the donor survives the initial QPRT term, the interest in the personal residence used to fund the QPRT will be removed from the donor's estate for federal and state estate tax purposes.

The discount in the value of the gift upon QPRT funding is driven by two factors: first, the donor's retained income interest in the residence (the right to occupy the residence for a certain period of time) and, second, the retained possibility of reversion in the case of the death of the donor during the initial QPRT term. QPRTs are a form of grantor retained income trust. In 1990, when Chapter 14 was added to the Internal Revenue Code, the use of grantor retained income trusts was limited and replaced by grantor retained annuity trusts and grantor retained unitrusts. § 2702. However, section 2702 contains a specific exception for trusts that hold interests in personal residences. One significant advantage of the QPRT strategy is its statutory basis. Unlike other strategies without a specific statutory basis (e.g., installment sales to grantor trusts), here the Code and Regulations specifically identify this entity and provide instructions for its creation and use, including requisite provisions for trust agreements. The Service even issued a model QPRT. (See Rev. Proc. 2003-42, attached as Appendix A). A

second important advantage of the QPRT strategy is that there is little downside risk to it. Either the donor survives the initial QPRT term and the trust property is excluded from the donor's estate or the donor does not survive the initial QPRT term and the trust property is included in the donor's estate and the gift tax exemption allocated to the initial gift is returned to the donor's estate.

C. Efficiency

The efficiency of a QPRT strategy is typically optimized in a high interest rate climate, because that will result in a larger discount of the initial gift and a smaller resulting value of the gift upon creation. QPRTs are also more efficient if funded when real property values are low or depressed. The current low interest rate climate (June 2012 § 7520 rate of 1.2%) is not optimal for QPRT efficiency as it is historically low, but that may be offset somewhat by the current depressed real estate values. Other factors, such as the age of the donor and applicable discounts for any fractional interest in the personal residence used to fund the QPRT, also will impact the efficiency of the QPRT strategy. Remember that § 7520 rates for each month are issued prior to the end of the prior month.

D. Most Common Format

A typical QPRT is an irrevocable trust created by an individual donor and funded by a transfer of such donor's interest in a personal residence to the trust. In Oregon, when a married couple desires to employ a QPRT strategy as to a specific residence owned as husband and wife, the spouses usually execute a deed transferring ownership of the real property to themselves as tenants in common. In Washington, when a married couple desires to employ a QPRT strategy, the spouses usually execute a deed transferring ownership of the real property from the marital community to the spouses as their respective separate property. Each spouse then funds his or her own QPRT with his or her separate interest in the real property. This strategy hedges against the mortality risk of the death of either spouse during the initial QPRT term. If either spouse dies during the initial QPRT term, only the portion of the personal residence used to fund the deceased spouse's QPRT will be included in the decedent's estate. This portion of the QPRT strategy will have failed, but the QPRT created by the surviving spouse will continue and may succeed. The survivor may also create a second QPRT for the portion of the personal residence that was included in the decedent's estate, now with a stepped-up income tax basis. Since a fractional interest in the property is used to fund each QPRT, a discount for the fractional interest of the personal residence used to fund each QPRT is typically applied when calculating the gift upon funding.

> **Example 1:** H and W are a married couple and are Oregon residents. They own a residence with a fair market value of $1,000,000 as tenants by the entirety. There is no mortgage on the residence. To implement a QPRT strategy, they

first execute a deed transferring ownership of the property to themselves as tenants in common. Next, they each execute a QPRT. Then each executes a deed transferring his or her 50% tenant-in-common interest in the residence to his or her QPRT. They file federal gift tax returns reporting the gifts to the QPRTs. For purposes of the calculation of the gift reported on those returns, the value of the interest in the residence that each contributed to his or her QPRT would typically be reduced by a discount based upon the fractional nature of the interest in the property. (See *Ludwick v. Commissioner,* T.C. Memo 2010-104.)

Example 2: Same facts as above, except H and W are Washington residents. They own the residence as their community property. To implement a QPRT strategy, they first execute a deed transferring ownership of the property from the marital community to themselves as each of their separate property. Then they continue with the process as outlined in Example 1 above.

E. Generation-Skipping Transfer Tax Issue

One trap for the unwary is that the estate tax inclusion period ("ETIP") rule applies to gifts to QPRTs. The ETIP is the period during which, if the donor died, the transferred property would still be included in the donor's estate or the estate of the donor's spouse. § 2642(f)(3). The Code provides that any allocation of GST exemption to such property may not be made before the close of the estate tax inclusion period. § 2642(f)(1). Because, if the donor of a QPRT dies during the initial QPRT term, the QPRT property will be included in the donor's gross estate under § 2036(a)(1), it is not possible to allocate GST exemption to a QPRT until the end of the initial QPRT term. This removes the ability to leverage the GST exemption with a QPRT in the same way the gift tax exemption can be leveraged. Because the GST exemption may not be allocated until the end of the initial QPRT term, the retained interest of the donor is not taken into consideration when valuing the gift at the time of the GST allocation, and the interest in the personal residence may have appreciated during the initial QPRT term.

In addition, because of the predeceased parent rule for generational assignment, there is a tax risk associated with the potential death of a child of the donor during the initial QPRT term. If a child of the donor is deceased upon the creation of the QPRT, the descendants of that deceased child move up a generation for GST purposes. § 2651(e)(1). However, if a child of the donor dies during the initial QPRT term, his or her descendants do not move up a generation for GST purposes, because the generation assignment for the deceased parent exemption takes place at the time of the completion of the transfer for gift tax purposes. In most cases, QPRT agreements name either the donor's then-living children who survive the initial QPRT term or a follow-on trust for such children as remainder beneficiaries. It is very rare for a QPRT agreement

to name the donor's then-living issue, by right of representation, as remainder beneficiaries, because the death of a child of the donor after the QPRT funding could lead to a termination for GST purposes upon the expiration of the initial QPRT term. Donors often provide a make-up provision under their other dispositive documents to address the possibility that the descendants of a child who dies during the initial QPRT term would not benefit from this typical QPRT format.

F. Technical Corrections

Treasury Regulation § 25.2702-5(c)(9) provides that, after May 16, 1996, QPRTs must prohibit the sale of the personal residence to the donor, the donor's spouse, or an entity controlled by the donor or the donor's spouse during the initial QPRT term or during any period after that term when the trust is a grantor trust. Until 1996, it was possible and simple to transfer an appreciated residence that had been used to fund a QPRT back to the estate of the donor to obtain a stepped up income tax basis on the donor's death. This is no longer the case. The basic issue is discussed at III.E.

III. COMMON SITUATIONS THAT ARISE DURING THE ADMINISTRATION OF QPRTS

A. Sale of Residence

1. Under the Regulations, a QPRT may allow for the sale of the residence during the initial QPRT term and the reinvestment of all or a portion of the proceeds in a new personal residence. Unfortunately, the sale transaction is rarely as simple as it could be.

a. If the purchase price of new residence is less than the sale proceeds of the old residence, the overage must be converted to a grantor retained annuity trust (GRAT) (see III.B. below), spent on capital improvements (see Reg. §25.2702-5(c)(5)), or distributed to the donor if permitted by the QPRT agreement (see III.E.2 below). Distribution back to the donor is typically not tax-efficient, but it may be desirable in certain circumstances.

> **Example:** In the case of the QPRTs funded by H and W in II.D.1. above, the trustees sell the residence held in the QPRTs for $1,000,000, and the two QPRTs purchase a replacement residence for $900,000. Leaving aside closing costs, taxes, etc., this leaves $50,000 of cash proceeds in each QPRT.

b. If the purchase price of the new residence is greater than the sale proceeds of the old residence, the donor has several options. The most commonly elected options are (i) the donor contributes the difference to the existing QPRT or (ii) the donor purchases a portion of the new residence with the existing QPRT as tenants in common. If the donor will purchase a portion of the residence in the donor's name, the donor may retain title in donor's name or contribute such interest to the existing QPRT or to a new QPRT. If cash or an interest in the new

residence is contributed to the existing QPRT, the gift calculation will be based upon the age of the donor at the time of contribution, the term remaining of the initial QPRT term, and the § 7520 rate in effect upon the date of contribution. There should be a valuation discount applicable to the value of the fractional interest of the residence held in the donor's name if it is contributed to a new or existing QPRT. (See *Ludwick* case cited above.) Contributions of cash to the existing QPRT in this case may not be efficient, unless the purchase price differential is quite small.

> **Example:** In the case of the QPRTs funded by H and W in II.D.1. above, the trustees sell the residence held in the QPRTs for $1,000,000, and the two QPRTs plan to purchase a replacement residence for $1,200,000. Leaving aside closing costs, taxes, etc., there is a shortfall of $200,000 for the purchase of the replacement residence.

c. Timing issues also can affect the sale of a residence. Clients often purchase a new residence before selling the old residence held in the QPRT. This creates several problems. First, a QPRT may hold an interest in only one residence. Second, if the donor takes title to the new residence in the donor's name and then sells the old residence from the QPRT, the proceeds from such sale will be in the QPRT and the QPRT will need to purchase the new residence from the donor, thus potentially generating an additional level of real estate excise tax. In an optimal situation, the closing of the sale of the old residence occurs just before the closing of the sale on the new residence. It is usually prudent to schedule the closings at least a week apart.

The timing issues are more workable when the sale of the old residence is to one or more children/descendants of the donor. Under Reg. § 25.2702-5(c)(9), a QPRT must prohibit the sale of the residence to the donor, the donor's spouse, or an entity controlled by either of them while the QPRT is a grantor trust, but there is no prohibition against a sale to a child or descendant of the donor.

Do not forget that each spouse may maintain two QPRTs at one time. It is sometimes possible to have a nondonor spouse create a QPRT for a new residence to avoid timing issues if the couple has sufficient assets.

B. Conversion of QPRT to a GRAT

1. If the interest in a residence used to fund a QPRT is sold and the proceeds are retained by the QPRT but not reinvested in a replacement residence within two years, or if such residence ceases to be used or held for use as the donor's residence, the QPRT must pay an annuity to the donor for the remaining initial QPRT term. Reg. § 25.2702-5(c)(8). If the QPRT is converted to a GRAT, the trustee calculates the annuity payments due to the donor by using the § 7520 rate and mortality rates in effect upon the creation of the QPRT, not at the time of the conversion. Note that multiple GRAT conversions can take place from a single QPRT (e.g., if the initial residence is sold and only a portion of the proceeds reinvested in a replacement residence

and then at some point in the future such replacement residence is sold and those proceeds are not reinvested). To comply with Rev. Proc. 2003-42, in the case of multiple GRAT conversions from a single QPRT, it is probably necessary to create separate shares for each GRAT conversion.

2. Conversion of a QPRT to a GRAT can be a useful method of providing money back to a donor who needs it, but it typically requires the sale of the residence. Sale of the residence and conversion to a GRAT may be useful where the donor needs money for health expenses or otherwise or where the increase in estate tax exemption renders the initial planning underpinnings of the QPRT less meaningful (as long as the donor desires to sell the residence). Conversion to a GRAT can be useful where the donor must move to an assisted living situation and requires assets for monthly payments, but does not need access to the entire principal of the QPRT.

C. Funding a QPRT with Mortgaged Property or Refinancing Property Held in a QPRT

1. It is possible to fund a QPRT with a personal residence that is subject to a mortgage or deed of trust. Typically, the initial gift to the QPRT will be calculated only on the value of the donor's equity in the residence. In this situation, the donor may give the QPRT cash to make mortgage payments if (a) such payments are reasonably expected to be made within six months from the transfer of such cash to the QPRT and (b) any mortgage principal payments made by the donor will be treated as additional gifts to the QPRT. It may be possible, if the donor remains legally obligated to personally pay off the mortgage, for the fair market value of the mortgaged residence to be used to calculate the initial gift. (See PLR 9340009.) Some commentators question the viability of this approach. If at all possible, the best practice is for the donor to pay off the mortgage prior to funding the QPRT.

2. It can be difficult to refinance a loan on property held in a QPRT. Banks typically do not like to loan to irrevocable trusts. At times, to refinance a loan, lenders propose that the trustee of the QPRT distribute the real property out of the QPRT "for one day," refinance the loan, and then transfer the property back to the QPRT. *Do not do this.* This type of proposal represents the lender's fundamental lack of understanding regarding the QPRT. The lender may do this with revocable trusts, but it is not possible or prudent in the case of QPRTs.

3. What to do when a client contacts you to let you know that, as part of a refinance that has already occurred, the residence was distributed back to the client/donor? Practical advice—contact the lender/individual who prepared the quitclaim deed and have the lender prepare another deed to transfer the residence back to the QPRT. In a sense, this is the correction of a unilateral or mutual mistake. The trustee and remainder beneficiaries could likely compel this result because the trustee had no authority to distribute the residence to the donor during the initial QPRT term.

D. Expiration of Initial QPRT Term; Holdover Donor

If the donor continues to occupy the subject residence after the expiration of the initial QPRT term, it is imperative that the donor pays to the remainder beneficiary of the QPRT (typically either children or a follow on trust) fair market value rent for the use of the residence. Failure to pay such rent will usually result in inclusion of the fair market value of the residence in the donor's gross estate as a result of a retained interest by the donor under § 2036. The donor and the remainder beneficiary should execute a lease/rental agreement for the residence. An independent, qualified party should determine the fair market value rent for the property. Realtors familiar with the local rental market often are able to provide a letter opinion regarding fair market value rent.

1. In a situation where the QPRT expires but the parties (donor and remainder beneficiary) fail to execute a lease agreement and the donor has not paid fair market value rent to the beneficiary, the prudent course is to have the donor pay the back rent due and to put a lease in place.

2. Some practitioners use the § 2036 retained interest to attempt to obtain a stepped-up basis in the residence where the donor has adequate estate tax exemption available. Thus, if the donor remains in the residence without paying fair market value rent, the residence should be included in the donor's estate and be eligible to receive a stepped-up basis. The appearance of an agreement in this situation is problematic.

3. It should be possible to use a nonjudicial settlement agreement (in Oregon, ORS 130.045) or a nonjudicial agreement (in Washington, RCW 11.96A, the Trust and Estate Dispute Resolution Act ("TEDRA")) to address certain issues that may arise at the end of the initial QPRT term. For example, the initial QPRT term of a QPRT created in the early 1990s may be set to expire and distribute to a trust for the benefit of the donor's children, but the QPRT may have been drafted so that the follow-on trust would not be a grantor trust for income tax purposes. If this resulted from a scrivener's error or other mistake, the interested parties (under ORS 130.045 or RCW 11.96A.220) may be able to correct the mistake.

E. Early Termination of QPRT

1. Situations. There are many situations that may develop for a client who has created a QPRT that could lead the client to conclude that he or she no longer desires to be subject to the QPRT. Clients may have a vastly different appreciation of the word "irrevocable" as it is used in the phrase "irrevocable trust." Some of these situations include a terminally ill donor, a desire for stepped-up basis of residence, increased federal estate tax exemption, or a desire to control the residence after the death of the initial donor when no follow on trust was initially included.

2. Options to Consider in These Situations

a. Review the Terms of the QPRT. Is there any way for a distribution to be made from the QPRT to the donor? Some QPRT agreements include a grant of authority to the trustee (or, if the donor is serving as trustee, to a special trustee) to distribute trust assets to the donor within 30 days of the QPRT ceasing to be a qualified trust. Reg. §25.2702-5(c)(7) and (8). In some circumstances it may be acceptable to intentionally cause the QPRT to cease to be a qualified trust. In this manner, the trust assets could be distributed back to the donor. This will likely waste the gift tax exemption already allocated upon creation of the QPRT, but depending on the value of the donor's estate and the estate tax exemption, that may be a realistic option.

b. Donor Purchase of the Remainder Interest. Consider having the donor purchase the remainder interest from children if possible under the spendthrift clause. The donor would become the sole owner of the residence, and the trust would terminate. The value of the remainder interest would be calculated under the IRS tables. Children may have income tax liability on the sale proceeds. The typical spendthrift provision may need to be altered to allow for such sale by the donor. For example, some trust agreements grant to the remainder beneficiaries, other than the donor, a limited ability to assign or transfer any interest in the QPRT. It should be possible to include such provision without damaging the important protections of the typical spendthrift provision (affording protection against the creditors of the remainder beneficiaries).

c. Purchase by Remainder Beneficiaries. Consider the purchase by the remainder beneficiaries of the donor's retained interest if possible under the spendthrift clause. Children would become sole owner of residence, and the trust would terminate. This requires the children to have adequate resources with which to make the purchase. It will also require the donor to vacate the residence or begin to pay rent to the children. The residence will be out of the donor's estate, even if the donor dies during the initial QPRT term. If this option appeals to the donor, consider granting in the QPRT agreement the power to the donor to assign or transfer the donor's interest in the trust. Note that the model QPRT issued under Rev. Proc. 2003-42 (attached as Appendix A) prohibits such sale by the donor, but the Regulations do not contain that prohibition.

d. Convert to a GRAT. See III.B. above. This strategy has the advantage of providing a stream of payments to the donor but requires that the residence be sold and the proceeds not invested in a replacement residence or that the residence cease to be used or held for the use of the donor's residence. Thus, this option may not be helpful when the donor does not wish to sell the residence and plans to reside in it.

e. Terminate the QPRT? Does the nuclear option exist here? Clients may seek legal and practical advice. *Under the Regulations, it is*

not possible to commute a QPRT. Reg. § 25.2702-5(c)(6). Some considerations are as follows.

i. Oregon. Under ORS 130.200(1), the court may approve the modification or termination of an irrevocable trust if the settlor and beneficiaries consent to such modification or termination, *even if* such modification or termination "is inconsistent with a material purpose of the trust." Further, under ORS 130.200(2), the court may approve the termination of an irrevocable trust if the beneficiaries consent and the court determines that "continuance of the trust is not necessary to achieve any material purpose of the trust." Even if all beneficiaries do not consent, the court may terminate an irrevocable trust if it concludes that the trust could have been terminated if all beneficiaries consented and the interests of the nonconsenting beneficiaries are protected. ORS 130.200(5). To terminate a trust without court involvement, "interested parties" may enter into a nonjudicial settlement agreement under ORS 130.045. ORS 130.200(6).

ii. Washington. Under RCW 11.96.070(4), as introduced as part of the 1984 Trust Act, the court could confer on the personal representatives or trustees any necessary or desirable powers that the court determines "are not inconsistent with the provisions or purposes of the will or trust." RCW 11.96.070(4). RCW 11.96.070 also allowed interested parties to enter into a written agreement resolving any matter under RCW 11.96.170. Thus, the interested parties could enter into an agreement to terminate an irrevocable trust if it was determined that such termination was not inconsistent with the purposes of the trust. In 1999, RCW 11.96.070 was integrated into RCW 11.96A.030(1), which defined a "matter" to include any question or dispute involving the grant to a personal representative or trustee of any "necessary or desirable power not otherwise granted in the governing instrument or given by law." RCW 11.96.030(1)(d). The official comments of the drafting committee, which were adopted by the House and Senate Judiciary Committee staffs, noted that the definition of "matter" was changed to remove the requirement of a determination that the requested action "not be inconsistent with the purpose of the will or trust." Comments to SB 5196 (1/28/1999) §104(1) RCW 11.96A.030. Thus, it is clear from the legislative history of TEDRA that a nonjudicial agreement by the interested parties may be used to terminate a trust.

iii. Issues to Consider If Contemplating Terminating a QPRT

(A) Under the Regulations, it is not possible to commute a QPRT. Reg. § 25.2702-5(c)(6).

(B) Who are the "interested parties" that are required to join in the agreement under ORS 130.045 or RCW 11.96A.220?

(C) Will a virtual or special representative be required to represent unborn, unascertained, or minor parties?

(D) If the residence will be distributed back to the donor, will there be a reportable gift by the remainder beneficiaries (often children) to the donor?

(E) Will any gift tax exemption allocated to the initial QPRT funding be returned to the donor's estate in the calculation of adjusted taxable gifts? Note that this is a different situation than a death of the donor during the initial QPRT term. (See III.G. below.)

F. Amendment of QPRT

As described above, state law may grant the parties interested in a QPRT some ability to amend a QPRT when all such parties agree.

G. Death of Donor During Initial QPRT Term

A typical QPRT provides that if the donor dies before the end of the initial QPRT term, the trust terminates and the interest in the residence held in the QPRT reverts to the donor's estate. The interest in the residence will receive a stepped-up basis for income tax purposes, and the gift tax exemption applied to the initial gift to the QPRT will be recovered by the estate of the donor. The mechanics of such recovery take place in the calculation of adjusted taxable gifts for the deceased donor's federal estate tax return. On the federal estate tax worksheet for taxable gifts (Worksheet TG—Taxable Gifts Reconciliation, attached as Appendix B) there is a separate column for gifts that are included in the estate (Column C). The value of gifts reported in Column C is subtracted from the value of taxable gifts reported on line 2, Column B, so the value of the initial QPRT gift is not included in adjusted taxable gifts. Because the amount of the gift upon funding is not counted as a taxable gift, it does not reduce the federal estate tax exemption as it would if the donor had survived the term.

IV. CONCLUSION

The QPRT is a powerful estate planning tool. It is important to understand the circumstances under which its leverage is maximized. It is also important to make sure that clients understand the features and limitations of a QPRT strategy before entering into a QPRT agreement. However, practical options for addressing administration issues that arise after the QPRT strategy has been implemented do exist.

APPENDIX A—REV. PROC. 2003-42

Part III

Administrative, Procedural and Miscellaneous

26 CFR 601.201: Rulings and determination letters.
(Also Part I, § 2702; 25.2702-5.)

Rev. Proc. 2003-42

SECTION 1. PURPOSE

This revenue procedure contains an annotated sample declaration of trust and alternate provisions that meet the requirements under § 2702(a)(3)(A) of the Internal Revenue Code and § 25.2702-5(c) of the Gift Tax Regulations for a qualified personal residence trust (QPRT) with one term holder.

SECTION 2. BACKGROUND

Section 2702(a) provides special rules for the valuation for gift tax purposes of a transfer of an interest in a trust to or for the benefit of a member of the transferor's family if the transferor (or an applicable family member) retains an interest in the trust. Under § 2702(a)(2)(A), the value of any retained interest that is not a qualified interest (as defined in § 2702(b)) is treated as zero unless the transfer is described in § 2702(a)(3). Section 2702(a)(3)(A) and § 25.2702-5(a)(1) provide that § 2702(a) does not apply to a transfer to a personal residence trust; that is, a transfer of an interest in trust all the property of which consists of a residence to be used as a personal residence by persons holding term interests in the trust. Although there are differences between a personal residence trust created under the statute and a QPRT created under the regulations, under § 25.2702-5(a), a trust meeting the requirements of a QPRT will be treated as a personal residence trust. Section 25.2702-5(c) contains the requirements that must be met by a trust in order to qualify as a QPRT. This revenue procedure provides a sample declaration of trust, as well as additional guidance in the form of annotations and alternative provisions.

SECTION 3. SCOPE AND OBJECTIVE

Section 4 of this revenue procedure provides a sample declaration of trust for a QPRT with one transferor for a term equal to the lesser of the life of the term holder or a term of years. Section 5 provides annotations to the provisions in the sample trust. Section 6 provides samples of certain alternate provisions concerning: (.01) additions to

the trust to purchase a personal residence, and (.02) disposition of trust assets on cessation of its qualification as a QPRT.

The Internal Revenue Service will recognize a trust as a QPRT meeting all of the requirements of § 2702(a)(3)(A) and § 25.2702-5(c) if (i) the trust instrument is substantially similar to the sample in section 4 of this revenue procedure or if the trust agreement properly integrates one or more alternate provisions from section 6 of this revenue procedure into a document substantially similar to the sample in section 4, and (ii) the trust operates in a manner consistent with the terms of the trust instrument and is a valid trust under applicable local law. A trust instrument that contains substantive provisions in addition to those provided in section 4 of this revenue procedure (other than properly integrated alternate provisions from section 6 of this revenue procedure or provisions necessary to establish a valid trust under applicable local law), or that omits any of the provisions of section 4 of this revenue procedure (unless an alternative provision from section 6 of this revenue procedure is properly integrated), will not necessarily be disqualified, but will not be assured of qualification under the provisions of this revenue procedure. The Service generally will not issue a letter ruling on whether a trust with one term holder qualifies as a QPRT. The Service, however, will generally issue a letter ruling on the effect of substantive trust provisions, other than those contained in sections 4 and 6 of this revenue procedure, on the qualification of a trust as a QPRT.

SECTION 4. SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST - ONE TERM HOLDER

This trust agreement is made this _____day of _____, 20 ____, by and between, _____, (hereinafter “the Transferor”), and as the trustee (hereinafter “the Trustee”), hereby creating the _____ Trust.

ARTICLE I. RETAINED INTEREST AND IRREVOCABILITY

A. Retained Interest. The Transferor intends to establish a qualified personal residence trust within the meaning of Rev. Proc. 2003-42, § 2702(a)(3)(A) of the Internal Revenue Code (hereinafter “the Code”), and § 25.2702-5(c) of the Gift Tax Regulations (hereinafter “the regulations”). Accordingly, the Transferor retains no right, title, or interest in any trust asset except as specifically provided in this trust instrument.

B. Irrevocable. This trust is irrevocable and therefore may not be modified, amended, or revoked by the Transferor or any other person. Notwithstanding the preceding sentence, however, the Trustee shall have the power, acting alone, to amend the trust to the extent provided in § 25.2702-5(a)(2) of the regulations (or any subsequent regulation or statute) in any manner required for the sole purpose of ensuring that the trust qualifies as a qualified personal residence trust for purposes of § 2702(a)(3)(A) of the Code and § 25.2702-5(c) of the regulations (including with respect to the grantor retained annuity trust (“GRAT”) administered under Article III, the

qualification of the annuity interest under § 2702(b)(1) of the Code and § 25.2702-3 of the regulations).

ARTICLE II. QUALIFIED PERSONAL RESIDENCE TRUST

A. Funding of the Qualified Personal Residence Trust ("QPRT").

(1) Residence. The Transferor transfers and assigns to the Trustee all of the Transferor's interests in and rights to certain real property, including all improvements thereon and appurtenances thereto, known as _____[legal description and/or address]_____ , _____[city]_____, _____[state]____. This property, or any property acquired as a replacement, will hereinafter be referred to as the "Residence." The Trustee accepts the Residence and agrees to hold, manage, and distribute the Residence and any other trust property under the terms set forth in this instrument.

(2) Assets of Trust. Except as provided in Paragraphs A(3), B(6), and D of this Article II, the Trustee is prohibited from holding, at any time during the term of the QPRT, any property other than (a) an interest in one (and only one) Residence that meets the requirements of a personal residence of the Transferor as set forth in § 25.2702-5(c)(2) of the regulations, and (b) policies of insurance on the Residence.

(3) Additions to QPRT. From time to time, the Trustee may accept an addition of cash to the QPRT in an amount which, when added to any cash already held, does not exceed the amount reasonably required for: (a) the payment of QPRT expenses (including without limitation mortgage payments) already incurred or reasonably expected to be paid by the trust within 6 months after the date the addition is made; (b) the cost of improvements to the Residence to be paid by the trust within 6 months after the date the addition is made; and (c) the purchase by the trust of a replacement Residence within 3 months after the date the addition is made, provided that no addition may be made, or held by the Trustee, for the purchase of a replacement Residence unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence. The Trustee shall hold the additions of cash received in accordance with this paragraph in a separate account.

B. Administration of Trust.

(1) Use and Management of Residence. The Trustee shall hold and maintain the Residence as a personal residence of the Transferor during the period beginning on the date of creation of the trust and continuing through the date of termination of the

trust (hereinafter "the term of the QPRT"). During the term of the QPRT, the Transferor shall have the exclusive rent-free use, possession, and enjoyment of the Residence.

(2) Payment of Expenses. The Transferor shall be responsible for the payment of all costs associated with the Residence, including but not limited to mortgage payments, property taxes, utilities, repairs, maintenance, and insurance. The Trustee's responsibility for the maintenance of the Residence and for other costs associated with the Residence is limited to the extent of any trust income and additions of cash for that purpose received by the Trustee in accordance with this Article II. If the Trustee has insufficient funds to pay these costs and expenses, the Trustee shall notify the Transferor, who shall be responsible for the unpaid balance of these costs and expenses. In addition, the Trustee from time to time may make improvements to the Residence, but the Trustee's authority and responsibility to do so is limited to the extent of any trust income, insurance proceeds, and additions of cash for that purpose received by the Trustee in accordance with this Article II.

(3) Distributions of Cash to Transferor. Any net income of the QPRT shall be distributed to the Transferor, not less frequently than annually. In addition, the Trustee shall determine, not less frequently than quarterly, whether the cash held by the QPRT exceeds the amount permitted to be held by the Trustee and shall immediately distribute the excess, if any, to the Transferor. Within 30 days of the date of the termination of the QPRT, the Trustee shall distribute outright to the Transferor (or to the estate of the Transferor, as the case may be), any amounts held by the QPRT pursuant to Paragraph A(3) of this Article II that are not used to pay QPRT expenses due and payable on the date of termination (including expenses directly related to the termination of the QPRT).

(4) Reinvestment of Trust Assets. Except as provided in Paragraph B(5) of this Article II, the Trustee may sell the Residence from time to time upon terms and conditions the Trustee deems appropriate. The Trustee may disburse from time to time any part or all of the amounts described in Paragraph A(1) and A(3) above and Paragraph B(6) below, including all income and capital gains thereon, as the Trustee deems appropriate for the purchase or construction of a replacement Residence to be owned by the trust or for the reconstruction or repair of the Residence. These disbursements shall be made, and any reconstruction and repairs shall be completed, within the time periods necessary to allow this trust to continue to qualify as a QPRT, but the Trustee shall not be held liable for any failure in this regard unless the Trustee has acted (or failed to act) through willful default or gross negligence.

(5) Prohibition on Sale of Residence to Transferor or Related Parties. The Trustee is prohibited from selling or transferring (as defined in § 25.2702-5(c)(9) of the

regulations) the Residence, directly or indirectly, to the Transferor, the Transferor's spouse, or an entity controlled by the Transferor or the Transferor's spouse during the retained term interest of the QPRT, or at any time after the termination of the retained term interest in the QPRT while the trust is treated as owned in whole or in part by the Transferor or the Transferor's spouse under §§ 671 through 678 of the Code.

(6) Receipt of Proceeds With Respect to Residence. If the Residence is sold, the Trustee shall hold the proceeds of the sale (along with any income accrued thereon) in a separate account. If the Residence is damaged, destroyed, or involuntarily converted within the meaning of § 1033 of the Code, the Trustee shall hold any proceeds payable as a result thereof (consisting either of insurance proceeds in the case of damage or destruction to the Residence or the proceeds payable upon involuntary conversion) in a separate account. The proceeds (and any interest thereon) so received shall be held, administered, and distributed by the Trustee as provided in this Article II.

(7) Commutation of Interests. The Transferor's interest in the QPRT may not be sold, commuted, or prepaid by any person.

(8) Prohibited Distributions. Except to the extent provided in Paragraph D below, the Trustee may not make any distribution of income or principal from the QPRT to or for the benefit of any person other than the Transferor prior to the termination of the QPRT.

C. Termination of Trust. The trust's date of termination shall be the earlier of [date], or the date of the Transferor's death. Except as otherwise provided in Paragraph D below, the Trustee shall distribute the trust property at the end of the term of the QPRT as provided in this Paragraph C. If the date of termination is [date], the Trustee shall distribute all of the property of the trust (other than any amounts due the Transferor pursuant to this trust instrument) to [designate transferees - if more than one, specify shares]. If the date of termination is the earlier death of the Transferor, the Trustee shall distribute all trust property (other than any amounts due the Transferor's estate pursuant to this trust instrument) to [designate transferees - if more than one, specify shares].

D. Cessation of Qualification as a Personal Residence Trust.

(1) Cessation Date.

(a) The trust shall cease to be a QPRT on the date on which the Residence ceases to be used or held for use as a personal residence of the Transferor within the

meaning of § 25.2702-5(c)(7) of the regulations (other than for reasons described in Paragraphs D(1)(b) or D(1)(c) below).

(b) In the event of a sale of the Residence, the trust shall cease to be a QPRT on the first to occur of the following: (i) the date which is 2 years after the date of sale; (ii) the date of termination as determined in Paragraph C above; or (iii) the date on which a replacement Residence is acquired by the Trustee. If the first to occur is the acquisition of a replacement Residence by the Trustee, then the QPRT shall continue with respect to that replacement Residence, and the trust shall cease to be a QPRT only to the extent of any sale proceeds then held by the Trustee and not used for the purchase of the replacement Residence.

(c) If the Residence is damaged or destroyed, thus making it unusable as a personal residence, the trust shall cease to be a QPRT on the first to occur of the following dates: (i) the date that is 2 years after the date of damage or destruction; (ii) the date of termination as determined in Paragraph C above; or (iii) replacement of or repairs to the Residence are completed or a new Residence is acquired by the Trustee. If the first to occur is the completion of the replacement or repair (or the acquisition of a new Residence), then the QPRT shall continue with respect to the repaired Residence or the new Residence, and the trust shall cease to be a QPRT only to the extent of any insurance proceeds then held by the Trustee and not used for the replacement or repair of the Residence (or the purchase of the new Residence).

(2) Distribution on Cessation. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any of its assets, and after satisfying the provisions of Paragraph B(3) of this Article II, the Trustee shall distribute the trust assets with respect to which the trust has ceased to qualify as a QPRT to a separate share of this trust to be referred to and administered as a GRAT in accordance with Article III below. That GRAT shall continue until the date of termination as defined in Paragraph C above.

(3) Multiple GRATs. Because it may be possible to have more than one cessation of qualification during the term of the QPRT, the Trustee shall create and fund a separate GRAT for each cessation and each GRAT shall be administered as a separate share of the trust in accordance with Article III below.

ARTICLE III. GRANTOR RETAINED ANNUITY TRUST

Each GRAT administered as a separate share under this Article III (each of which is referred to as “the GRAT” with regard to that separate share) is intended to provide for the payment of a qualified annuity interest as defined in § 25.2702-3 of the

regulations for the benefit of the Transferor. No amount shall be paid before the termination of this trust other than to or for the Transferor's benefit.

A. Right to Receive Annuity. In each taxable year of the GRAT, beginning with the year beginning on the cessation date (as defined below), the Trustee shall pay to the Transferor an annuity, the amount of which shall be determined in accordance with Paragraph D of this Article III. The right of the Transferor to receive the annuity amount begins on the cessation date.

B. Cessation Date. The cessation date is the date on which the Residence ceases to be used or held for use as a personal residence of the Transferor, the date of sale of the Residence, or the date of damage to or destruction of the Residence that renders the Residence unusable as a residence, as the case may be.

C. Payment of Annuity. The annuity amount shall be paid in equal [insert monthly, quarterly, semi-annual or annual] installments. The annuity amount shall be paid first from the net income of the GRAT and, to the extent net income is not sufficient, from principal. The Trustee may defer payment of any annuity amount otherwise payable after the cessation date until the date that is 30 days after the date that the assets are converted to a GRAT as provided in this trust instrument. Any deferred payment of the annuity amount shall bear interest for the period of deferral, compounded annually, at a rate not less than the rate prescribed in § 7520 of the Code in effect on the cessation date. The Trustee shall reduce the aggregate deferred annuity payments by the amount of income actually distributed to the Transferor during the deferral period.

D. Computation of Annuity Amount.

The amount of the annuity payable to the Transferor shall be determined as follows.

(1) If, on the date that any property of the trust is converted from the QPRT to a GRAT (hereinafter the "conversion date"), the assets of the trust do not include a Residence used or held for use as a personal residence of the Transferor, the annuity shall be the amount determined by dividing the lesser of (a) the value of the interest retained by the Transferor (as of the date of the original transfer) or (b) the value of all the trust assets (as of the conversion date) by the annuity factor determined (i) for the original term of the Transferor's interest and (ii) at the rate used in valuing the retained interest at the time of the original transfer to the QPRT.

(2) If, on the conversion date, the assets of the trust include a Residence used or held for use as a personal residence of the Transferor, the annuity shall be the amount determined under subparagraph (1) of this Paragraph D multiplied by a fraction. The numerator of the fraction is the excess of the fair market value of the assets of the trust on the conversion date over the fair market value of the assets as to which the trust continues as a QPRT, and the denominator of the fraction is the fair market value of the trust assets on the conversion date.

(3) In computing the annuity amount for any second or subsequent GRAT to be administered under this Article III, the Trustee shall make appropriate adjustments to the formulas above in this paragraph D that are consistent with the applicable provisions of the Code and the regulations thereunder and with the Transferor's intent to maintain qualification of each of the trust shares hereunder as a QPRT or a GRAT.

(4) If there is an error in the determination of the annuity amount, then, within a reasonable period after the error is discovered, the difference between the annuity amount payable and the amounts actually paid shall be paid to or for the use of the Transferor by the Trustee in the event of an underpayment, or shall be repaid by the Transferor to the Trustee in the event of an overpayment.

E. Proration. Notwithstanding the preceding paragraphs of this Article III, in determining the annuity amount for a short taxable year, the Trustee shall prorate the annuity amount on a daily basis. In determining the annuity amount for the taxable year of the termination of the GRAT, the Trustee shall prorate the annuity amount for the final period of the annuity interest on a daily basis.

F. Additional Contributions Prohibited. No additional contributions shall be made to the GRAT after its creation.

G. Termination of GRAT. The GRAT shall continue through the date of termination of the QPRT, as defined in Paragraph C of Article II, and shall then terminate. Upon termination of the GRAT, the Trustee shall distribute all of the trust property in the manner described in Paragraph C of Article II as if the GRAT property had been part of the QPRT disposed of under that provision.

H. No Commutation. The Transferor's interest in the annuity amount may not be sold, commuted, or prepaid by any person.

ARTICLE IV. GENERAL PROVISIONS

A. Taxable Year. The taxable year of the trust shall be the calendar year.

B. Governing Law. The operation of the trust shall be governed by the laws of the state of [state]. The Trustee, however, shall not have or exercise any power or discretion granted under applicable law that would prevent: (1) the QPRT administered under Article II above from meeting the requirements for a qualified personal residence trust under § 2702(a)(3)(A) of the Code and § 25.2702-5(c) of the regulations; or (2) the Transferor's interest in any GRAT administered under Article III above from meeting the requirements for a qualified annuity interest under § 25.2702-3 of the regulations.

SECTION 5. ANNOTATIONS REGARDING SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST

.01 Annotations for Introductory Paragraph and Article I, Retained Interest and Irrevocability.

(1) Qualification as a QPRT. In order to qualify as a QPRT, the governing instrument must contain all the provisions required under the regulations, and these provisions must by their terms continue in effect during the existence of any term interest in the trust. Section 25.2702-5(c)(1).

(2) Appointment of Trustee. Alternative or successor trustees may be designated in the trust instrument.

(3) Limited Power of Amendment. A QPRT must be irrevocable. However, modification of a trust by judicial reformation (or nonjudicial reformation if effective under state law) to comply with the requirements of § 25.2702-5(c) will be effective for purposes of § 2702, provided the reformation is commenced within 90 days after the due date (including extension) for the filing of the gift tax return reporting the transfer of the residence under § 6075 and is completed within a reasonable time after commencement. Section 25.2702-5(a)(2).

.02 Annotations for Article II, Qualified Personal Residence Trust

(1) Requirement that QPRT Must be Funded With a Personal Residence (Article II, Paragraph A(1)). The QPRT must be funded with a residence that qualifies as a personal residence of the term holder during the term of the QPRT. A personal residence of a term holder is: (A) the principal residence of the term holder (as that term is defined in § 25.2702-5(c)(2)(i)(A)); (B) one other residence of the term holder (within the meaning of § 25.2702-5(c)(2)(i)(B)); or (C) an undivided fractional interest in a residence described in either (A) or (B). Section 25.2702-5(c)(2)(i). A personal residence may include appurtenant structures used by the term holder for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes, taking into account the residence's size and location. The fact that a residence is subject to a mortgage does not affect its status as a personal residence.

The term “personal residence” does not include any personal property, for example, household furnishings. Section 25.2702-5(c)(2)(ii). A residence is a personal residence only if its primary use is as a residence of the term holder when occupied by the term holder. The principal residence of the term holder will not fail to meet the requirements of the preceding sentence merely because a portion of the residence is used in an activity meeting the requirements of § 280A(c)(1) or (4) (relating to deductibility of expenses related to certain uses), provided that such use is secondary to use of the residence as a residence. A residence is not used primarily as a residence if it is used to provide transient lodging and substantial services are provided in connection with the provision of lodging, for example, a hotel or a bed and breakfast. A residence is not a personal residence if, during any period not occupied by the term holder, its primary use is other than as a residence. Section 25.2702-5(c)(2)(iii).

(2) Assets other than personal residence (Article II, Paragraph A(3)). This is an optional provision that, if included in the trust instrument, permits the trustee to accept additions of cash to the trust for the purposes set forth in Paragraph A(3) of Article II. A provision in the trust instrument that permits these additions is not required in order to qualify the trust as a QPRT. Section 25.2702-5(c)(5)(ii)(A). In addition, the trust instrument may permit improvements to the residence to be added to the trust and may permit the trust to hold such improvements, provided the residence, as improved, meets the requirements of a personal residence. Section 25.2702-5(c)(5)(ii)(B).

(3) Authority to Sell or Repair Residence (Article II, Paragraph B(4)). The provisions of Paragraph B(4) are optional. If the trustee is given the authority to sell the personal residence but not to reinvest the proceeds in a replacement personal residence, the trust ceases to be a QPRT upon the sale of the residence.

(4) Prohibition on Sale of Residence to Transferor or Related Person (Article II, Paragraph B(5)). The governing instrument must prohibit the trust from selling or transferring the residence directly or indirectly to the transferor, the transferor’s spouse, or an entity controlled by the transferor or the transferor’s spouse during the retained term interest in the trust or at any time after the expiration of that interest when the trust is a grantor trust. For these purposes: (A) a sale or transfer to another grantor trust of the transferor or the transferor’s spouse is considered a sale or transfer to the transferor or the transferor’s spouse; and (B) a “grantor trust” is a trust that is treated as owned in whole or in part by the transferor or the transferor’s spouse pursuant to §§ 671 through 678, and “control” is as defined in § 25.2701-2(b)(5)(ii) and (iii).

This prohibition, however, does not apply to a distribution for no consideration either to: (i) another grantor trust of the transferor or the transferor’s spouse, if the

distributee-grantor trust includes the same prohibition against a sale or transfer; (ii) the transferor's spouse after the term of the QPRT; or (iii) any person pursuant to the trust instrument or the exercise of the transferor's retained power of appointment, if any, if the transferor dies prior to the expiration of the retained term interest. Section 25.2702-5(c)(9).

(5) Termination of Trust (Article II, Paragraph C).

(a) Termination on Death of Transferor. If the trust terminates by reason of the death of the transferor, and therefore terminates prior to the end of the term interest, the trust property will be includible in the transferor's gross estate for federal estate tax purposes because the transferor will have retained an interest in the trust for a period that did not in fact end before the transferor's death. Section 2036(a)(1). Therefore, consideration should be given to designing the dispositive provisions to take advantage of marital or charitable deductions that may be available for estate tax purposes.

(b) Generation-Skipping Transfer Tax. Consideration also should be given to potential generation-skipping transfer (GST) tax consequences under § 2601 upon termination of the trust by reason of the death of the transferor during the QPRT term. The transferor may prefer to design the dispositive provisions to avoid any generation-skipping transfer in the event of the transferor's death during the term because, pursuant to § 2642(f), no allocation of GST exemption can be made until the end of the term of the QPRT (the transferor's death).

(6) Cessation of Use As a Personal Residence (Article II, Paragraph D).
The governing instrument must provide that a trust ceases to be a QPRT if the residence ceases to be used or held for use as a personal residence of the term holder. Under § 25.2702-5(c)(7)(i), a residence is held for use as a personal residence of the term holder so long as the residence is not occupied by any other person (other than the spouse or a dependent of the term holder) and is available at all times for use by the term holder as a personal residence.

.03 Annotation for Article III, Grantor Retained Annuity Trust (GRAT).
(1) Payment of Annuity (Article III, Paragraph C). Allowing deferral of the annuity payment is an optional provision and is not required in order to qualify as a QPRT. If the trustee is given the power to defer payment of any annuity amount, then the trust may (but is not required to) provide that the aggregate deferred annuity payments must be reduced by the amount of income actually distributed to the tranferor during the deferral period. Section 25.2702-5(c)(8)(ii)(B).

(2) Computation of Annuity Amount (Article III, Paragraph D). The annuity amount may be greater than the amount identified in the sample trust, but may not be less than that amount. See Example 6 in § 25.2702-5(d) for a numerical example of how the annuity formulas operate.

.04 Annotation for Article IV, General Provisions.

Trustee Powers. The trust instrument may contain administrative provisions relating to the trustee's duties and powers, as long as the provisions do not conflict with the rules governing QPRTs under § 2702(a)(3)(A) and § 25.2702-5(c), or the rules governing qualified annuity interests under § 25.2702-3. A clause may be included that provides: "Except to the extent provided otherwise in Article II and Article III, the Trustee has the following powers . . .."

SECTION 6. ALTERNATIVE OR OPTIONAL PROVISIONS FOR SAMPLE QUALIFIED PERSONAL RESIDENCE TRUST

.01 Contribution(s) of Cash to Purchase Personal Residence.

(1) Explanation. If the transferor does not currently own the personal residence that will constitute the trust corpus, cash may be transferred to the QPRT for the purchase of the initial residence. However, the purchase must take place within 3 months of the date the trust is created. Except for a nominal amount that may be required under state law to create the trust, before any contribution, the trustee must have previously entered into a contract to purchase that residence. Section 25.2702-5(c)(5)(ii)(A)(iii).

(2) Instructions for use. Replace Paragraphs A(1) and A(3) of Article II with the following paragraphs:

> A(1) Cash for Purchase of Residence. The Transferor transfers $_____ to the Trustee and confirms that the Transferor intends to transfer to the Trustee additional cash in an amount sufficient to allow the Trustee to purchase a residence to be used as a personal residence of the Transferor. The Trustee accepts that amount, agrees to hold it in a separate account, and agrees to use it and any additional cash contributed under Paragraph A(3)(d) of this Article to purchase, within 3 months after the date on which this trust is created, such a residence (hereinafter referred to as "the Residence"). The Trustee agrees to hold, manage, and distribute the Residence and any other trust property under the terms set forth in this instrument.

A(3) Additions to QPRT. From time to time, the Trustee may accept an addition of cash to the QPRT in an amount which, when added to any cash already held, does not exceed the amount reasonably required for: (a) the payment of QPRT expenses (including without limitation mortgage payments) already incurred or reasonably expected to be paid by the trust within 6 months after the date the addition is made; (b) the cost of improvements to the Residence to be paid by the trust within 6 months after the date the addition is made; (c) the purchase by the trust of a replacement Residence within 3 months after the date the addition is made, provided that no addition may be made, or held by the Trustee, for this purpose unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence; and (d) the purchase by the trust of the initial Residence within 3 months of the date the trust is created, provided that no addition may be made, or held by the Trustee, for the purchase of the initial Residence unless the Trustee has, prior to receipt of the addition, entered into a contract to purchase that Residence. The Trustee shall hold the additions of cash received in accordance with this paragraph in a separate account.

.02 Disposition of Trust Assets on Cessation as QPRT.

(1) Explanation. The sample trust provides that, if the trust ceases to qualify as a QPRT, the assets are to be held as a separate share in a GRAT pursuant to which a qualified annuity interest is to be paid to the transferor until the QPRT's date of termination. Alternatively, the trust instrument may direct that the assets be returned to the transferor, or may give to a trustee, who is independent of the transferor, the discretion either to elect to return the assets to the transferor or to hold the assets in a GRAT. Section 25.2702-5(c)(8).

(2) Instructions for use if outright distribution**.** If the assets are to be distributed outright to the term holder, delete all of Article III, delete the reference to GRAT at the end of Paragraph B of Article I and Paragraph B of Article IV, delete Paragraph D(3) of Article II, and replace Paragraph D(2) of Article II with the following paragraph:

> D(2) Distribution on Cessation. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any assets, the Trustee shall distribute those assets outright to the Transferor.

(3) Instructions for use if trustee's discretion. If the trustee is to be given the discretion to either distribute the assets outright or establish a GRAT, replace Paragraph D(2) of Article II with the following paragraph:

D(2) Distribution on Cessation. Within 30 days after the date on which the trust ceases to be a QPRT with respect to any of its assets, and after satisfying the provisions of Paragraph B(3) of this Article II, the Trustee shall distribute any trust assets with respect to which the trust has ceased to qualify as a QPRT in one of two ways, as the Trustee may select in the Trustee's sole discretion. Specifically, the Trustee shall distribute the assets with respect to which the trust no longer qualifies as a QPRT either: (i) to the Transferor, outright; or (ii) to a separate share of this trust to be referred to and administered as a GRAT in accordance with Article III below. That GRAT shall continue until the date of termination as defined in Paragraph C above.

DRAFTING INFORMATION

The principal author of this revenue procedure is Mary Berman of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mary Berman on (202) 622-3090 (not a toll-free call).

APPENDIX B—WORKSHEET TG FROM FORM 706 INSTRUCTIONS

Worksheet TG and Line 4 Worksheet

Worksheet TG—Taxable Gifts Reconciliation
(To be used for lines 4 and 7 of the Tax Computation)

	a. Calendar year or calendar quarter	b. Total taxable gifts for period (see Note)	c. Taxable amount included in col. b for gifts included in the gross estate	d. Taxable amount included in col. b for gifts that qualify for "special treatment of split gifts" described below	e. Gift tax paid by decedent on gifts in col. d	f. Gift tax paid by decedent's spouse on gifts in col. c
Gifts made after June 6, 1932, and before 1977	1. Total taxable gifts made before 1977					
Gifts made after 1976						
2. Totals for gifts made after 1976						

Note. For the definition of a taxable gift, see section 2503. Follow Form 709. That is, include only the decedent's one-half of split gifts, whether the gifts were made by the decedent or the decedent's spouse. In addition to gifts reported on Form 709, you must include any taxable gifts in excess of the annual exclusion that were not reported on Form 709.

Line 4 Worksheet—Adjusted Taxable Gifts Made After 1976

1. Taxable gifts made after 1976. Enter the amount from Worksheet TG, line 2, column b		1	
2. Taxable gifts made after 1976 reportable on Schedule G. Enter the amount from Worksheet TG, line 2, column c	2		
3. Taxable gifts made after 1976 that qualify for "special treatment." Enter the amount from Worksheet TG, line 2, column d	3		
4. Add lines 2 and 3		4	
5. Adjusted taxable gifts. Subtract line 4 from line 1. Enter here and on Part 2—Tax Computation, line 4		5	

Note. You must complete *Part 2—Tax Computation*.

Line 1

If you elected alternate valuation on line 1, *Part 3—Elections by the Executor*, enter the amount you entered in the "Alternate value" column of item 12 of *Part 5—Recapitulation*. Otherwise, enter the amount from the "Value at date of death" column.

Line 3b. State Death Tax Deduction

The estates of decedents dying after December 31, 2004, will be allowed a deduction for state death taxes, instead of a credit. The state death tax credit was repealed as of January 1, 2005.

You may take a deduction on line 3b for estate, inheritance, legacy, or succession taxes paid as the result of the decedent's death to any state or the District of Columbia.

You may claim an anticipated amount of deduction and figure the federal estate tax on the return before the state death taxes have been paid. However, the deduction cannot be finally allowed unless you pay the state death taxes and claim the deduction within 4 years after the return is filed, or later (see section 2058(b)) if:

- A petition is filed with the Tax Court of the United States,
- You have an extension of time to pay, or
- You file a claim for refund or credit of an overpayment which extends the deadline for claiming the deduction.

Note. The deduction is not subject to dollar limits.

If you make a section 6166 election to pay the federal estate tax in installments and make a similar election to pay the state death tax in installments, see section 2058(b) for exceptions and periods of limitation.

If you transfer property other than cash to the state in payment of state inheritance taxes, the amount you may claim as a deduction is the lesser of the state inheritance tax liability discharged or the fair market value (FMV) of the property on the date of the transfer. For more information on the application of such transfers, see the principles discussed in Revenue Ruling 86-117, 1986-2 C.B. 157, prior to the repeal of section 2011.

You should send the following evidence to the IRS:

1. Certificate of the proper officer of the taxing state, or the District of Columbia, showing the:
   a. Total amount of tax imposed (before adding interest and penalties and before allowing discount),
   b. Amount of discount allowed,
   c. Amount of penalties and interest imposed or charged,
   d. Total amount actually paid in cash, and
   e. Date of payment.
2. Any additional proof the IRS specifically requests.

You should file the evidence requested above with the return, if possible. Otherwise, send it as soon after you file the return as possible.

Line 6

To figure the tentative tax on the amount on line 5, use *Table A — Unified Rate Schedule*, above, and put the result on this line.

Lines 4 and 7

Three worksheets are provided to help you figure the entries for these lines.

Chapter 7

WHAT IS SO SPECIAL ABOUT 2012? THE LOSS OF PLANNING TOOLS AS WE KNOW THEM?

Patrick J. Green[1]
Davis Wright Tremaine LLP
Portland, Oregon

Table of Contents

[1]The author credits Amelia E. Heath of Davis Wright Tremaine LLP for contributions to research and tables included in this outline.

I. INTRODUCTION—2012 A SPECIAL YEAR FOR PLANNING—DÉJÀ VU 1986?

In late 1986 when Congress significantly overhauled the Internal Revenue Code ("tax simplification"), lawyers, accountants, and financial advisors scrambled to implement planning in the last few months of 1986 to document and grandfather favorable elections for benefits that would disappear on January 1, 1987, under the new Code. The remaining six months of 2012 may be a repeat of 1986 as practitioners once again become extraordinarily busy advising clients and implementing planning opportunities that may disappear forever.

As we all know, predicting what Congress will or won't do to estate and gift tax laws and planning for clients accordingly has been difficult in the last few years. Nevertheless, given that 2012 is an election year and Congress has demonstrated increasing polarization, Congress may not act before year end to halt the reversion of the law to what was in place in 2001. If they fail to act in 2012, the new Congress seated in 2013 may not act for weeks or months, resulting in much uncertainty for planners and their clients. Given this background, proactive advisors and their clients should definitely discuss existing planning opportunities, consider potential changes, and consider action in the remaining six months of 2012 to capture disappearing benefits.

II. FADING OPPORTUNITIES FOR EFFECTIVE WEALTH TRANSFER PLANNING?

A. Chart

Significant tax changes are coming at year's end due to the sunset provisions of the now ten-year-old law. Multiple proposals before Congress would limit or eliminate some of the most effective gift and estate tax savings techniques that are currently available. Even if Congress fails to act on any of these proposals, higher tax rates and lower tax exemptions will return on January 1, 2013.

Federal Transfer Taxes	2012 Law	2013 Law	President's Proposal for 2013
Federal gift tax exemption	$5,120,000	$1,000,000	$1,000,000
Federal estate tax exemption	$5,120,000	$1,000,000	$3,500,000
Federal generation-skipping transfer tax exemption	$5,120,000	$1,300,000 (approx.)	$3,500,000
Gift and estate tax top rate	35%	55% (60% between $10 million and $20 million)	45%

Oregon Transfer Taxes	Current Law	Washington Transfer Taxes	Current Law
Oregon gift tax exemption	N/A	Washington gift tax exemption	N/A
Oregon estate tax exemption	$1,000,000	Washington estate tax exemption	$2,000,000
Federal generation-skipping transfer tax exemption	N/A	Washington generation-skipping transfer tax exemption	N/A
Estate tax top rate	16%	Estate tax top rate	19%

1. Rates. Federal estate and gift tax rates will likely increase, as will income tax rates.[1]

2. Exemptions. Federal estate, gift, and generation-skipping transfer tax exemptions will likely decrease. State estate tax exemptions will likely remain at their current low levels. State estate taxes may exceed the federal state death tax credit, which returns in 2013, due to increased state estate tax rates enacted since states decoupled and left the "pick-up tax" regime. For example, Oregon's marginal rate immediately above the $1,000,000 exemption is 10%, but the state death tax credit for $1,000,000 under the Code is 3.656%.[2] Does this result in a loss of the credit allowed under Section 2011, thus raising the effective federal estate tax rate? Would the authority to deduct the excess disappear with the sunset of Section 2058 after December 31, 2012?

A possible anomaly may occur if the federal estate tax exemption drops to $1,000,000 while the Washington state estate tax exemption remains at the higher $2,000,000 level. This may introduce some interesting drafting and administration issues where $2 million is set aside in a trust exempt for Washington purposes and a $1 million federal-only QTIP election is made to defer federal estate tax—the reverse of what we may have become used to doing in the past several years.

3. The "Greenbook." In addition to the return to the state of the law based upon the sunset of the 2001 legislation, on February 13, 2012, the Obama Administration released its (FY) 2013 Budget, and the Treasury Department released the General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (the "Greenbook"). Provisions relevant to gift, estate, and income tax planning are refer-

[1] 2013 law in the above chart reflects the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), which restores the law to what was in effect in 2001. The President's proposal is one of many proposals that Congress may consider that could result in post-2012 changes.

[2] IRC Section 2011.

enced throughout this outline. The Greenbook proposals, also referred to herein as the "President's proposals," would likely be enacted in 2013 (if enacted at all).

B. Grantor Retained Annuity Trusts (GRATs)

Internal Revenue Code Section 2702 authorizes the grantor to transfer wealth in trust and to retain an income interest in the form of an annuity from the trust—a technique referred to as a grantor retained annuity trust or "GRAT." The trust pays an annuity calculated using the term of the trust and an assumed rate of return[3] referred to as the "7520 rate" after the Code Section 7520, which establishes the rate at 120% of the mid-term applicable federal rate ("AFR"). If trust income or appreciation in trust assets exceeds the amount calculated to be paid as the annuity, the excess remaining in trust at the end of the term is paid to the trust remainder beneficiaries.

The gift tax cost is usually zero or minimal since the value of the grantor's retained annuity interest is equal to the present value of the future gift to be distributed to the trust beneficiaries upon termination of the trust. If the grantor survives the term of the trust, the trust property is removed from the grantor's taxable estate without transfer costs. If, however, the grantor dies during the term of the trust, the value of the trust property at the then date of death is included in the grantor's estate—a mortality risk.

Rapidly appreciating assets or property that produces income are ideal candidates for transfer to GRATs; especially to a two-year GRAT will transfer a significant amount of wealth. Examples of such property include real property undergoing zoning changes, pre-IPO stock, and assets throwing off significant income. If the property failed to perform in the short two-year term, the grantor can simply "reload," i.e., execute and fund another two-year GRAT to try to capture the next wave of performance.

The President's Greenbook proposal requires a minimum ten-year term for GRATs. The longer term will reduce the effectiveness of transferring property undergoing rapid appreciation, which, if captured in a two year GRAT, would transfer wealth quickly. Also, by extending the minimum term from two to ten years, the risk of inclusion of the value of the property in the grantor's estate due to mortality of the grantor within the term of the GRAT increases significantly. The chances of dying within ten years for an elderly grantor are much more significant than the probability of dying within two years.

C. Intentionally Defective Grantor Trusts/Grantor Deemed Ownership Trusts (IDGT/GDOTs)

Grantors who wish to transfer appreciating, income-producing property with little or no transfer tax cost may wish to sell the property on an installment sale note to a form of grantor trust know as an intentionally defective grantor trust ("IDGT") or as a grantor deemed

[3]Currently 1.28% in June 2012.

ownership trust ("GDOT"). The Code requires interest to be paid on the installment sale note at the "applicable federal rate" ("AFR"). These rates are based upon the term of the note and are currently very low.[4] Like the GRAT, the grantor is treated as the owner of the trust for income tax purposes. The grantor pays income tax on all of the income received by the IDGT. Like the GRAT, the intentional design "defect" that causes the grantor to pick up the income and loss from assets inside the trust permits additional wealth transfer by the grantor through paying income taxes attributable to the income in the IDGT. Payment of income tax is not considered an additional gift by the grantor. Furthermore, the payment of that cash removes that amount from the grantor's estate and allows the transfer of the property and its full appreciation inside the IDGT to pass to the beneficiaries, undiminished by the income taxes associated with income on that property during the term of the IDGT.

The IRS has ruled that the sale of an asset by a grantor of an IDGT to the IDGT does not result in capital gain or loss to the grantor, nor is the interest payable on the installment sale taxable income to the grantor.[5] The ruling reasoned that one cannot sell an asset to oneself (grantor to grantor trust) and therefore there should be no income tax consequence on the installment sale.

Notwithstanding the absence of income tax on capital gains or interest on the sale by the grantor, as indicated above, the grantor is responsible for paying income tax on income generated by the property while it is held by the IDGT. Therefore, if the property purchased by the trust generates interest, rents, royalties, or dividends, the grantor reports that income and personally pays the tax on that income. Because the IDGT is making payments of interest and principal to the grantor, the grantor, in a thoughtfully designed installment sale, will have cash to pay the income tax on income inside the IDGT, again without treating those payments as additional gifts to the beneficiaries who receive the property at the termination of the IDGT.

Although income produced by the property held by the IDGT is included in the grantor's income for income tax purposes, the property in the IDGT is excluded from the grantor's taxable estate. Only the balance of the remaining payments on the installment note received in exchange for the sale of the property to the IDGT is included in the grantor's estate.

However, under the President's proposal, an IDGT would become ineffective for wealth transfer as long as the trust was a grantor trust for income tax purposes. The proposal would treat grantor trusts currently classified as such for income tax rules as trusts subject to new gift and estate tax rules. The Treasury Green Book described the proposal as follows:

[4]Rate for short-term (less than three years) is .23%, mid-term (three to nine years) is1.07%, and long-term (over nine years) is 2.64% as of June 2012.

[5]Rev. Rul. 85-13, 1985-1 C.B. 184, 1985-7 I.R.B. 28.

> To the extent that the income tax rules treat a grantor of the trust as an owner of the trust, the proposal would (1) include the assets of the trust in the gross estate of the grantor for estate tax purposes, (2) subject to gift tax any distribution from the trust to one or more beneficiaries during the grantor's life, and (3) subject to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the trust for income tax. The transfer tax imposed by this proposal would be payable from the trust. This provision would affect grantor trusts established or funded after the date of enactment of this legislation.

While details are pending, this proposal may effectively kill sales to IDGTs as the heart of the technique is the tax-free sale of appreciating or income producing assets to a *grantor* trust, a technique that was blessed in Rev. Rul. 85-13, and the exclusion of the trust assets from the grantor's estate. If the existence of a grantor trust for income tax purposes creates gift tax for distributions during the life of the grant as well as upon termination of grantor status, growth and cash flow in excess of the interest and principal will not escape the transfer tax.

D. Irrevocable Life Insurance Trusts (ILITs)

Proceeds of life insurance provide liquidity for estates at a time when cash is needed most. Needs include but are not limited to funds for the payment of federal or state income or estate tax, retirement of outstanding debt that may become due as a result of the death of the debtor, equalization of estate distributions where business interests may be distributed to beneficiaries actively involved in the business, and for distributions to other beneficiaries or for buyouts of deceased business partners.

Proceeds of life insurance are included in the decedent insured's gross estate under IRC Section 2042 if the decedent's estate is the beneficiary or if the decedent held incidents of ownership in the policy where proceeds are receivable by other beneficiaries. To avoid diminishing the available proceeds from the impact of estate taxes, clients often establish irrevocable trusts to acquire the ownership of life insurance policies. This third-party ownership can remove the proceeds from the insured's estate and provide liquidity undiminished by estate tax when needed. These trusts are commonly referred to as irrevocable life insurance trusts or "ILITs."

Funding an ILIT during lifetime involves a transfer of cash from the insured to the trustee of the ILIT. This transfer is a gift; however, the gift does not qualify as a gift of a present interest qualifying for the annual exclusion of $13,000 per donee. However, under IRC Section 2503(b), the donor may claim the annual exclusion for transfers to the ILIT if beneficiaries of the ILIT are granted an unrestricted right to withdraw cash from the ILIT for a period of time following the deposit. Typically, the trustee provides a notice to the beneficiary(ies) of the ILIT of their

right to withdraw a designated portion of the cash prior to paying the premium. This right creates the present interest in the cash transfer and qualifies the gift for the annual exclusion.[6] Transfers of cash in excess of the annual exclusion amounts are treated as a part of the donor's lifetime exemption (unless "hanging powers" are used). Therefore, if the insured wishes to acquire a large policy where premiums exceed annual exclusion amounts, contributions to the ILIT, the donor will generally use available lifetime exemption to cover the additions to the trust.

1. 2012 vs. 2013. Given the large lifetime gift tax exemption of $5,120,000 available only in 2012 (assuming that the gift tax exemption falls to $1,000,000 in 2013), an ILIT established this year may be funded with up to $5,120,000 (plus annual exclusion amounts applicable to the number of beneficiaries). That cash transfer could potentially purchase a policy five times larger than would be available next year given the five-fold difference in the gift tax exemption. This may be a one-time opportunity to acquire an extraordinary amount of insurance as a leveraged gift or for liquidity needed for one or more of the reasons stated above. For donors who do not need that much insurance but wish to both acquire insurance through an ILIT and to make gifts of other assets, the current gift tax exemption allows for much more flexibility in meeting both objectives this year.

2. President's Proposals. Under the President's proposals, the proceeds of life insurance in an ILIT would *not* be excluded from the insured's estate due to the overly broad attack on grantor trusts. As previously mentioned, the target of the attack on grantor trusts focuses on sales of assets to IDITs. However, the effect of targeting this type of grantor trust with an inclusion of the value of the assets at death in the estate of the grantor would be to include the proceeds of most insurance policies on the life of the grantor held by ILITs as most ILITs are grantor trusts. An ILIT that can use trust income without the approval or consent of any adverse party to purchase a life insurance policy on the life of the grantor is considered a grantor trust for income tax purposes.[7]

E. Discounts for Valuation Purposes

Estate planners work with real estate and business appraisers to establish values for tax purposes whether it is for gift, estate, or income taxation. Appraisers routinely factor in these discounts using generally accepted appraisal principals based upon data in the marketplace. The IRS recognized that such discounts in the family context were allowable in Rev. Rul. 93-12. For families, valuation discounts for lack of control and marketability allow transfers of larger interests in property to family members by gift or inheritance. These discounts have become an integral and routine tool in estate planning.

That may soon change. Under the President's proposal, discounts for the lack of control and marketability would be severely lim-

[6] *Crummey v. Commissioner,* 397 F.2d 82 (9th Circuit 1968).

[7] IRC Section 677(a)(3).

ited for lifetime or death transfers of property in the family context. This would be accomplished by including additional categories of restrictions in IRC Section 2704(b), referred to as "disregarded restrictions," that would have the effect of eliminating discounts in transfers of entity interests within the family. Although the target of previous proposals, discounts in the family context have survived in the past. Whether or not they will continue is still uncertain, but this attack may gain some traction as it acts as a revenue raiser without raising rates.

F. Generation-Skipping Transfer Tax Restrictions

Transfers during life or at death to individuals or trusts for beneficiaries who are two or more generations younger than the transferor ("remote beneficiaries") are subject to the generation-skipping transfer tax (GST) unless the GST exemption is applied to that transfer. Because the GST imposes an additional layer of tax over and above the gift or estate tax, nonexempt GST transfers are generally avoided as too expensive.[8]

A GST exemption applied to a GST transfer is exempt from the GST tax and therefore offers an opportunity to transfer a large amount of wealth to lower generations without the GST tax. If the transfer also falls within the gift or estate tax exemption, the transfer is fully free of tax. Transfers to a long-term trust (sometimes referred to as a "dynasty" or "perpetual trust") in a jurisdiction that has eliminated the rule against perpetuities (or extended the rule) may fund a trust that will never be subject to gift, estate, or GST tax. These trusts are often thought of as a "family bank" as a source for loans for buying a home, starting a business, funding tuition for higher education, and the like.

1. 2012 vs. 2013. The GST exemption for 2012 is $5,120,000 but is expected to fall to $1,300,000 in 2013 (approximate estimate based upon indexing for inflation). The gift tax exemption for 2012 is also $5,120,000 but will fall to $1,000,000 in 2013 unless Congress changes the law. Therefore, a gift of $5,120,000 to more remote beneficiaries (or in trust for such beneficiaries) in 2012 is fully exempt from gift and GST tax. This may be a one-time opportunity to exempt a large transfer from the transfer tax system. If a husband and wife were to join in such a transfer, the exempt amount can be doubled to $10,240,000. Using valuation discounts referred to above, it may be possible to transfer up to $15,000,000 of wealth during 2012 using this technique (using a conservative 33% combined discount for absence of control and lack of marketability). In 2013, only $1MM would be absolutely free of both gift and GST tax during lifetime ($2MM if transferred by a married couple).

2. Greenbook. The Greenbook proposes to limit the effectiveness of GST exempt trusts to a term not to exceed 90 years from the date of creation of the GST trust. This would be accomplished by increasing the inclusion ratio of the trust to *one* on the 90th anniversary of the date of the creation of a trust. This would terminate the trust's

[8] IRC Sections 2601–2664.

GST exemption. The rule would also impact pour-overs to existing GST-exempt trusts and to trusts created under the decanting rules with a limited exception that allows some flexibility for a trust for a then incapacitated beneficiary.

III. ACTION PLAN FOR 2012

A. Client Conversations

Many practitioners around the country have engaged their clients in conversations in the last 18 months and will surely continue to discuss potential changes in the law and existing planning opportunities that may disappear six months from now. These discussions must include the risks that Congress may change the law, proposed changes may never be enacted, and planning involving irrevocable techniques will, regardless of the various possible outcomes in the law, stay in place and might restrict future flexibility.

B. Potpourri of Gift Alternatives

1. Outright Gifts. Cash, stock, bonds, and other property may be given outright as the simplest form of gifts for 2012. In spite of their seeming simplicity, however, due to the age or capacity of the donees, the need to control future ownership changes or to structure governance for the property, gifts in the form of limited liability interests, trusts, or gifts using the Uniform Transfer to Minors Act may add a layer of complexity.

2. Creation of New Indebtedness. For parents or grandparents who don't wish to part with their principal but also do not depend upon income from that principal for living, loans to children or grandchildren provide cash to family for reinvestment or for acquiring assets without high borrowing costs. Interest-only term loans can be made at historically low AFR interest rates.[9] Although the note balance is included in the creditor's estate for estate tax purposes, unlike an investment, the principal of the note is effectively "frozen," resulting in wealth transfer to children or grandchildren assuming their reinvestment.

3. Forgiveness of Existing Indebtedness. Don't overlook gifts of outstanding indebtedness. Many parents have loaned funds to their children to acquire a home, for example. Although such gifts generally require a minimum interest payment, it may be years before such loans can be repaid, if they ever will be repaid during the parent's lifetime. Simply forgiving an obligation when the parent neither needs or expects to be repaid is a simple form of gift in 2012.

4. Split Gifts. Married couples may choose to split the value of the gift given by one individual into two gifts provided that they both file respective gift tax returns electing such treatment. Splitting the gift may double the available annual exclusions and can preserve more of

[9]Rate for short-term (less than three years) is .23%, mid-term (three to nine years) is1.07%, and long-term (over nine years) is 2.64% as of June 2012.

the exemption for each donor for further gifts or to be reserved for application at death.

5. Tuition. Payment for tuition to an educational organization for the education or training of an individual is exempt from the gift tax and can be paid in addition to annual exclusion gifts.[10]

6. Medical. Payment to any person who provides medical care for an individual for such medical care is also exempt from the gift tax and can be paid in addition to annual exclusion gifts.[11]

7. 529 Plans. Contributions to 529 plans, which take their name from Code Section 529, offer a source of tax-advantaged funding for children, grandchildren, or others. Contributions are treated as present interest gifts qualifying for the annual exclusion (currently $13,000).[12] Contributions in excess of the $13,000 annual exclusion will be treated as made ratably over five years upon election of the donor.[13] These front-loaded contributions begin to generate tax-advantaged returns immediately within the plan and do not reduce the donor's lifetime gift tax exemption.

8. UTMA. Lifetime gifts to these accounts are common. Remember that if the donor acts as the custodian, the assets in the UTMA account will be included in the donor's taxable estate for estate tax purposes if death occurs while the account is open. The donor should simply consider appointing a trusted friend or relative as custodian to avoid this result as the assets in the UTMA account will not be included in the taxable estate of the custodian under those facts.

9. IRC Section 2503(c) Trusts. Gifts for individuals who have not yet turned 21 are considered present interest gifts qualifying for the annual exclusion if the property and the income from that property may be expended by of for the benefit of such individual before reaching age 21 and to the extent not so spent will pass to the donee on reaching age 21 or to the donee's estate if deceased prior to age 21 (or passing under the decedent's general power of appointment). Gifts to trusts, known as "2503(c) trusts," qualify.[14] Therefore, management of a gift may be provided for a minor by a trustee and still qualify for the annual exclusion.

10. Two Year GRAT. Establish a zeroed-out, two-year GRAT with assets capable of rapid appreciation or significant income in excess of the 1.28% 7520 rate—wealth transfer for the excess without using the lifetime gift tax exemption while maintaining a low mortality risk.

11. Sale of Asset to IDGT. Since the Greenbook proposal to modify the tax attributes of GRATS would become effective upon enact-

[10] IRC Section 2503(e)(2)(A).

[11] IRC Section 2503(e)(2)(B).

[12] IRC Section 529(c)(2)(A).

[13] IRC Section 529(c)(2)(B).

[14] IRC Section 2503(c).

ment, transactions set up with IDGTs in 2012 should be grandfathered, resulting in an escape from this potentially deal-killing proposal.

12. Establish and Fund an ILIT. Although the overly broad attack on grantor trusts in the Greenbook proposal would adversely impact ILITs as grantor trusts, this result seems short-sighted. If the exemption amount falls and the rates rise, decedents will pay more estate tax. ILITs have provided a means to pay the estate tax with funds that are exempt from estate tax. If those funds will now be subject to estate tax, it will be more expensive to use life insurance in this fashion to provide the needed liquidity—somewhat of a dog-chasing-its-tail situation. What is uncertain is whether existing ILITs will be exempt from this change in the law. Therefore, setting up an ILIT in 2012 may present some risk. Historically, such arrangements have been grandfathered from future law changes. The insurance industry is also a very effective lobby and may convince Congress that this change would be unwise. Assuming that the law does not go into effect or does not adversely impact existing ILITs, funding an ILIT in 2012 using the larger exemptions may be a one-time benefit that should be discussed and possibly implemented with clients this year.

C. Lifetime Spousal Exemption Trusts/Spousal Access Trusts/ Spouse and Family Exempt Trust (LSTs/SATs/SAFE Trust)

What if your client wishes to lock in the high gift tax exemptions in 2012 but feels insecure parting with the income and or the principal? The use of lifetime spousal exemption trusts, also known as spousal access (a "SAT") or spouse and family exempt trusts (a "SAFE trust") have gained popularity in the last 18 months. Spouse A sets up an irrevocable trust for spouse B for life, remainder to children. The SAT includes a power exercisable by Spouse B in Spouse B's will that allows Spouse A to enjoy the income for life upon Spouse B's death should Spouse B predecease Spouse A. Instead of using the marital deduction provisions such as a QTIP election, Spouse A reports this irrevocable gift as a taxable gift and applies the exemption available in 2012 to that gift. This strategy allows up to $5,120,000 to be placed into a SAT. Of course, this strategy is not without risk. Spouse B may not exercise the power of appointment in favor of Spouse A. And there is always the possibility of divorce!

In significant estates, both spouses may choose to set up SATs for each other, taking full advantage of the combined $10,240,000 of exemptions available in 2012 to a couple. In addition to the previously mentioned risks, the SATs must be drafted to avoid the "reciprocal trust doctrine," an IRS tool used to uncross "mirror image" trusts and to include the assets established by each settlor in the settlor's estate, an outcome that renders the two SATs ineffective for estate tax exclusions. Also, transfers between spouses before establishing two SATs can raise step-transaction arguments for the Service, which could undo the planning and result in inclusion of the asset in the transferor's estate.

Careful drafting around the application of the reciprocal trust and step-transaction doctrine requires substantive differences in the trusts.

1. To avoid the step-transaction doctrine and the use of IRC Sections 2036(a)(1) and (2), the following steps should be considered.

✦ If all assets are owned by Spouse A, transfers to Spouse B should be accomplished well in advance of Spouse B establishing a SAT for Spouse A.

✦ The settlor/grantor spouse should select a trustee for the SAT other than the spouse or should appoint a cotrustee with the spouse where the cotrustee can act alone regarding distributions.

✦ Avoid gift-splitting.

2. To avoid the reciprocal trust doctrine, substantive differences such as in the following steps should be considered.

✦ Income and principal beneficiaries should materially differ. For example, Spouse B may be the income and principal beneficiary of the SAT established by Spouse A, while the SAT established by Spouse B for Spouse A may be secondary to children as income and principal beneficiaries and only in the case of emergencies.

✦ Spouse B receives a limited power of appointment in favor of Spouse A while Spouse A receives no power, but the SAT authorizes a trust protector to alter the distribution upon Spouse A's death.

✦ Spouse B serves as trustee of the SAT established by Spouse A, but children serve as trustee of the SAT established by Spouse B.

✦ The mix of assets may differ—real property or business assets held in one trust held for long-term with fungible assets (publicly traded stocks and bonds) in the other trust.

3. Features of the SAT are attractive:

✦ Spouse B may be trustee of the SAT established by Spouse A;

✦ Spouse B may enjoy access to principal as well as income based upon an ascertainable standard (health, education, maintenance, and support ("HEMS");

✦ Spouse B may hold a limited power of appointment exercisable in a will in favor of Spouse A should Spouse B predecease Spouse A.

D. Irrevocable Life Insurance Trusts

Based upon the discussion above, consider the following strategy in 2012.

✦ Establish an ILIT funded by the grantor with a one-time deposit of cash up to the available gift tax exemption of $5,120,000.

✦ Use these funds to acquire a large insurance policy on the grantor's life.

✦ Alternatively, a married couple may consider funding the ILIT with up to double this amount ($5,120,000 × 2 = $10,240,000) to acquire a second-to-die policy that pays proceeds at the death of the surviving spouse, when estate taxes are generally due.

✦ Have your cake and eat it too by using a significant portion of the gift tax exemption to establish and fund an ILIT and use the balance of the exemption to fund another tax-advantaged gift technique. In 2013, you would likely be restricted to using fewer techniques or funding them at lower levels.

✦ Prohibit the use of income to pay premiums on the policy(ies), or require the approval of an adverse party for such payment to avoid grantor trust status, which should avoid inclusion of the proceeds of insurance in the grantor's estate under the President's proposal.[15]

E. Valuation Discount Planning

Gift fractional interests of assets or of entities created to own property using valuation discounts. While two levels of appraisals are generally advisable (one for the property and the other for interests in the entity owning the property), the expense of appraisals is usually minimal in comparison with the benefits of leveraging the lifetime exemption of up to $5,120,000 at discounted values. Assuming a 33% discount, an asset worth $7,775,000 could be given within one $5 million exemption ($7,775,000 × .67), or an asset worth $15,000,000 within two exemptions equal to $10 million ($15 million × .67).

F. GST Planning with Long-Term Trusts (Dynasty/Perpetual)

Gifts of up to $5,120,000 ($10,240,000 for a married couple) can be made to skip generations (grandchildren and beyond) without gift or GST tax in 2012. Most grandparents will not want to give substantial value to skip persons outright due to concerns about the impact of the donee's unfettered access to wealth. However, gifts into a long-term (dynasty or perpetual) trust restrict access, allow for management, and keep the wealth intact—free from death tax for successive generations. Therefore, clients should consider gifts of amounts up to their large GST exemption available in 2012 to a GST exempt trust, filing a gift tax return for 2012 and applying the GST exemption to the gift, resulting in no gift or GST tax. If the GST-exempt trust is established in a jurisdiction that repealed the rule against perpetuities or enacted an extremely long term for trusts, the trust may grow unaffected by death taxes for generations.

Under the President's proposal, the risk to current GST-exempt gifts in trust is that the value of the trust assets will no longer be subject to an exemption from GST tax in 90 years. However, gifts using the 2012

[15] IRC Section 677(a) General rule

The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

. . . .

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions)).

GST and gift tax exemptions can be five times as large as in 2013, and the growth in 90 years can be substantial.

G. Lifetime Gifts as They Impact Oregon and Washington Estate Tax

Remember that neither Oregon nor Washington impose a tax on lifetime gifts. Lifetime gifts remove those assets, including their growth and income, from the donor's taxable estate for estate tax purposes in Oregon and Washington. Therefore, lifetime gifts within the federal exemptions save estate tax imposed upon the decedent's estate for state purposes. This is neither new nor novel; however, due to the large federal gift and GST tax exemptions available in 2012, donors can give substantially more this year than they will be able to give next year, and the reduction of state estate taxes will be much more significant than if they wait until next year.

H. Due Diligence

1. "Claw Back"? Over the last few years, commentators have raised the specter of a possible glitch in the law that could result in recapturing tax benefits at death from lifetime gifts that used gift tax exemptions that exceeded the estate tax exemption applicable at death. For example, if a donor used her full $5,120,000 gift tax exemption in 2012 but died in 2013 when the estate tax exemption was $1,000,000, arguably the estate tax calculation at death that takes into account previous gift exemptions and gift tax payable could apply a tax at death that ignored the previously higher lifetime exemption.

Several commentators have analyzed this problem and have come down on both sides of the issue—some believe that "claw back" is real and requires legislative action to remedy,[16] while others believe that the "sunset" provisions of the law itself avoids this outcome.[17]

A detailed analysis of this risk is beyond the scope of this outline; however, the issue should be discussed as a risk with clients even though the likelihood of an adverse outcome from "claw back" based upon analysis and Congressional intent has been minimized.

2. Income Tax and Balancing Transfer Tax Costs Savings Against Income Tax Savings—i.e., the Stepped-Up Basis. Assuming a

[16]Jones, Mike, *Estate Planning Newsletter* #1925 (LISI February 16, 2012), at http://www.leimbergservices.com/, and proposed legislation, Section 2(c) of H.R. 3467 of the "Sensible Estate Tax Act of 2011," H.R. 3467, introduced on November 17, 2011, by Congressman Jim McDermott (D–WA), which would avoid the "claw back" that could recapture benefits obtained by the current large gift tax exemption if the donor died at a time when the estate tax exemption would be lower than today. It prevents the applicable exclusion amount used to calculate the hypothetical gift tax to be subtracted under Section 2001(b)(2) from exceeding the applicable exclusion amount used to compute the tentative estate tax. This proposed legislation will not likely become law due to very significant rate hikes and permanent lower exemption at $1,000,000, albeit indexed to inflation.

[17]Leimberg, Evans, Dan, *Estate Planning Newsletter* #1929 (LISI February 23, 2012), at http://www.leimbergservices.com/.

return to higher estate and gift tax rates as well as to higher income tax rates in 2013, the estate tax applicable to an asset passing from a decedent to heirs with a stepped-up basis at death[18] should be compared to the income tax rates applicable to the sale by the donees of a gifted asset with the donor's basis. For smaller estates just over $1,000,000, the estate tax may be significantly less than the capital gain and ordinary income taxes if the donor's basis is very low.

3. Timing of Gifts to Avoid Step-Transaction Doctrine and Indirect Gift Treatment. Taking advantage of higher gift tax exemptions in 2012 makes sense; however, only six months remain in this year to implement gift strategies. Transferors of membership interests of recently formed limited liability companies must carefully document each phase of the process and separate the formation and organizational phases in time from the wealth transfer phases. The IRS may use the step-transaction doctrine to collapse separate steps into one step, resulting in the loss of valuation discounts applicable to valuing the transferred membership interests. It may also apply the indirect gift rules, which also results in the loss of valuation discounts. The IRS has challenged such planning with some success.[19] Even if the taxpayer is successful, the cost and anxiety of litigation can be a risk.

4. Present-Interest Gifts. A gift of a present interest qualifies for the annual exclusion currently set at $13,000.[20] A present interest gift is one that confers current, not future, benefits to the donee. The IRS may assert that a gift of an interest in an entity such as membership interest in limited liability companies confers no present benefit to the donee due to the lack of any present right to enjoy the benefits of the interest based upon restrictions in the operating agreement. If the donee has no present right to enjoy the economic benefit of the interest, the donor may lose the right to apply the annual exclusion to this gift. The Service has enjoyed victories in a number of cases in this area and continues to assert this argument.[21]

[18] IRC Section 1014.

[19] *Gross v. Comm'r,* 96 T.C.M. (CCH) 187 (2008); *Heckerman v. United States,* 2009 WL 2240326 (W.D. Wash.); *Homan v. Comm'r,* 130 T.C. 170 (2008), *aff'd* 431 Fed. Appx. 544 (9th Cir. 2011); *Linton v. United States,* 638 F. Supp. 2d 1277 (W.D. Wash. 2009), *rev'd in part and remanded,* 630 F. 3d 1211 (9th Cir. 2011); *Pierre v. Comm'r,* 133 T.C. 24 (2009), *sup. by Pierre v. Comm'r,* 99 T.C.M. (CCH) 1436 (2010).

[20] IRC Section 2513.

[21] *Hackl v. Comm'r,* 118 T.C. 279 (2002), *aff'd,* 335 F. 3d 664 (7th Cir. 2003); *Price v. Comm'r,* 99 T.C.M. (CCH) 1995 (2010).