Testimony before Senate Judiciary Committee
In support of HB 2331
On behalf of the Oregon State Bar Estate Planning and Administration Section

May 6, 2015

Senator Prozanski, members of the Committee:

Good Afternoon. My name is Philip Jones and I am an attorney with Duffy Kekel LLP. I am here today with Eric Foster of Foster Denman LLP as representatives of the Estate Planning and Administration section of the Oregon State Bar in support of HB 2331.

Estate Planning and Administration Section

The Estate Planning and Administration section of the Oregon State Bar was originally formed in 1978, and today is made of up of over 1200 attorneys who practice estate planning and administration law in Oregon. We have members from 32 different Oregon counties, representing a wide variety of clients each with their own unique problems and concerns. The Executive Committee of the Estate Planning and Administration section of the bar supports HB 2331. After extensive review and discussion by estate planning attorneys, we believe we have crafted consensus legislation within the estate planning and administration legal community.

HB 2331 will make four changes to ORS Chapter 130, Oregon's Uniform Trust Code:

- Follow the federal internal revenue code rule known as the separate share rule and allow the trustor's intent regarding separate shares of trusts to control under ORS 130.232;
- Clarify that a trustee has the authority to combine or divide trusts under ORS 130.230,
- Authorize a fiduciary in Oregon to report gains from the sale or exchange of capital assets as distributable net income.
- Codify the early vesting rule that has been followed by the Oregon Supreme Court since 1911.

Separate Share Rule

The purpose of Sections 1 and 2 of HB 2331 is twofold:

(1) It allows the creator of a trust (also known as the trustor, settlor, or grantor) to provide in the trust document whether the trust will be divided into separate trusts or not. The legislation does not require any particular result, except that it generally requires the trust to be administered as indicated by the trustor in the trust document.
(2) It allows Oregon trusts to operate consistent with federal tax laws regarding the question of whether a trust is to be divided into separate trusts or trust shares.

ORS 130.232, enacted in 2013, can have the effect of changing the administration of a trust, contrary to the intention of the trustor. The original language of the trust, as created by the trustor, should govern, and the trustor's original language in the trust document should be allowed to determine whether a trust should be divided into several smaller trusts. The 2013 change also prevents the application of the separate share rule of Internal Revenue Code §663(c). The drafters of the 2013 change did not intend to prevent the application of the federal separate share rule, but that was the unintended consequence of the 2013 legislation.

The separate share rule can be summarized as follows: If a single trust (or an estate) is designed to benefit multiple beneficiaries and the terms of the trust or will prevent distributions to one beneficiary from affecting the interests of the other beneficiaries that single trust will continue to exist as a single trust, with separate trust shares. Internal Revenue Code §663(c) requires the application of the separate share rule, which results in the separate shares calculating their distributable net income (DNI) and their income distribution deduction separately, but the separate shares remain part of a single trust that has a single trustee and files a single income tax return. Reg. 1.663(c)-3. The separate share rule is stated very simply in §663(c), with nearly all of the detail provided in regulations. Reg. §1.663(c). The 2013 legislation, however, disregards the language of the trust, and forces the creation of multiple trusts which must then file multiple income tax returns. That result disregards the intent of the trustor and prevents the application of the federal separate share rule.

This proposed amendment to ORS 130.232 allows the intent of the trustor to control, and also gives the trustee flexibility to create separate trusts or separate trust shares. In particular, section 1 of the bill permits trusts to operate consistent with the federal separate share rule, and section 2 permits a trustee to operate a trust as separate trusts or as separate shares of a single trust, based on the provisions of the trust and the best interests of the beneficiaries.

<u>Distributable Net Income</u>

Under traditional accounting rules, when a trustee distributes money or property to a beneficiary of a trust that distribution will usually carry out ordinary income to the beneficiary. Usually, distributions of this type do not carry out capital gains. Thus, the trust holding capital gains proceeds will be responsible for the federal taxes on the capital gains rather than the beneficiaries.

Before 2013, whether capital gains were taxed to a trust or to the beneficiaries of a trust did not matter because the capital gains tax rates for trusts and individuals were at the same 15% federal tax rate. However, effective January 1, 2013, capital gains became subject to an additional tax and a capital gains tax rate increase. The new tax at the federal level is a surcharge of an additional 3.8% for trust income in excess of $12,300. Also beginning in 2013, capital gains held within a trust became subject to a new 20% maximum tax rate on long-term capital gains in excess of the $12,300 threshold.

If capital gains can be distributed to individual beneficiaries of trusts, the additional 3.8% surcharge on capital gains applies only when individual taxpayers, filing jointly, reach income of $250,000. The increased 20% capital gains tax rate only applies when individual taxpayers, filing jointly reach an income level of $450,000. So, it is more likely that a beneficiary will not incur the 3.8% surcharge and be

in the 15% bracket for long-term capital gains while the trust will be in the 20% capital gains bracket and the 3.8% surcharge bracket.

The Treasury Regulations authorize capital gains to be distributed to and taxed to beneficiaries, individually, in three situations: (1) a trustee makes an adjustment to allocate capital gains to income; (2) a trustee consistently includes capital gains as part of a beneficiary's distribution of principal; or (3) a trustee actually distributes capital gains to a beneficiary.

These three situations can already be authorized in trust documents. However, many existing trust documents do not authorize distribution of capital gains. This legislation would authorize capital gains distributions to beneficiaries under state law subject to the reasonable and impartial exercise of discretion limitations of the trust agreement. The legislation would have the impact of allowing trustees to distribute capital gains from existing irrevocable trusts to pass through capital gains to beneficiaries to avoid unduly burdensome federal tax rates on capital gains.

Early Vesting Rule of Trusts

The purpose of this section of HB 2331 is to codify longstanding Oregon case law regarding the date on which trust interests vest in the beneficiaries. Since 1911, the Oregon Supreme Court has consistently held that trust interests vest when the grantor of the trust created the trust or when the trust became irrevocable, and not at a later date, unless the trust document clearly indicates a different intent. That rule has become known as the early vesting rule. The early vesting rule has been very helpful in interpreting wills and trusts that do not indicate a vesting date. In 2013, ORS 130.730(1) was amended to create a vesting right whenever an event took place that required a distribution to be made from a trust. That amendment did not make clear that it was not intended to alter the pre-existing Oregon case law. The drafters of the 2013 legislation have indicated that they were unaware of the early vesting rule and did not intend to change it. In order to avoid any confusion, HB 2331 incorporates the early vesting rule while still retaining the 2013 amendment.

The cases following the early vesting rule are: *Dean v. First National Bank*, 217 Or 340, 360-61, 341 P2d 512 (1959); *Daniel v. Donohue*, 215 Or 373, 390, 333 P2d 887 (1959); *Williamson v. Denison and Groves*, 185 Or 249, 254-55, 202 P2d 477 (1949); *Roberts v. State Tax Commission*, 229 Or 609, 614-15, 368 P2d 342 (1962); *Quick v. Hayter*, 188 Or 218, 228, 215 P2d 374 (1950); *McCleery v. Woodmen of the World*, 136 Or 407, 419, 297 P 345 (1931); *Adkinson v. Bloomquist*, 128 Or 211, 274 P 312 (1929); *Kaser v. Kaser*, 68 Or 153, 158, 137 P 187 (1913); *Stevens v. Carroll*, 64 Or 417, 419, 129 P 1044 (1913); *Love v. Walker*, 59 Or 95, 109, 115 P 296 (1911); *Winslow v. Rutherford*, 59 Or 124, 128, 114 P 930 (1911). Accord, *McGee v. Dept. of Revenue*, 7 OTR 288, 292-95 (1977); John C. Paulus, "Future Interests in Oregon," 15 Willamette Law Review 151, 165-66 (1979). See "The Early Vesting Rule and the Rule Avoiding Intestacy," *Oregon State Bar Estate Planning and Administration Section Newsletter*, October 2013. There are no court cases in Oregon that conflict with the early vesting rule.