TRUST MODIFICATIONS IN OREGON

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Although it is the foundation of much estate planning, the "irrevocable trust" is really not so irrevocable. Many states, including Oregon, provide multiple ways to modify or to terminate irrevocable trusts. These materials provide an overview of trust modifications. They discuss the mechanisms for modification, focusing on nonjudicial settlement agreements (NJSAs) in particular, and alternatives to modification.

In addition to these materials, a very helpful resource is Brown & Sasaki, Modification, Revocation and Termination, Administering Trusts in Oregon, Ch. 16 (2018), published by the Oregon State Bar. Specifically, that chapter (in section 16.5) covers trust decanting, which these materials do not cover (first, because Oregon does not have a decanting statute, and second, because the author believes that other forms of modification described in these materials can achieve the same ends with less risk to the party doing the decanting).

I. OVERVIEW.

Before diving into mechanics, it is important to look at the big picture.

A. Why Modify?

Irrevocable trusts are modified for one reason only: to fix a trust problem. This problem can arise due to: (a) poor drafting initially; (b) changes in beneficiary circumstance; or (c) changes in the law. It is critical, therefore, to identify the real problem. A beneficiary who wants larger distributions from the trust, for instance, may not be a problem that is appropriate for fixing. That said, some reasons for modifying might include:

- Allowing for distributions to be made directly to service providers and landlords, rather than to a spendthrift beneficiary;
- Relaxing outdated restrictions or adding new ones;
- Terminating the trust altogether;
- Moving a trust from Oregon to Washington (and hiring a Vancouver trustee) to avoid state income tax on the sale of a trust asset (this also requires a change of situs under the Oregon Uniform Trust Code);
- Adding a trust protector to determine when distributions should be made;
- Allowing a trustee to invest in an asset concentration (like an interest in a family business);
- Indemnifying the trustee for making difficult decisions (like when the beneficiaries want the trustee to invest in that family business).

This list obviously isn't exhaustive, but it does give a sense of scope. The discussion on NJSAs, below, contains a list of statutory purposes for modification.

B. How Can it be Done?

Modification can happen in several ways:

First, a trust can be drafted to allow an independent party, like a trust protector, to modify the trust in any number of ways, broad or limited. The document can allow trustees to be removed and replaced, situs and governing law to be changed, distributions to be restricted, or trust terms to be lengthened or shortened. This list is by no means exhaustive; these are just a few provisions that are commonly included.

Second, an Oregon trust can be modified under a NJSA (described in Section II, below).

Third, an Oregon trust can be modified by the court using one of several judicial modification provisions (described in Section III, below).

Fourth, the definition of "income" can be modified using either the power to adjust or the power to convert to a unitrust (described in Section V, below).

Each of these techniques has advantages and disadvantages. Drafting with flexibility by including a trust protector can be the most efficient choice, but only if you have a wise and reliable trust protector. This can be rare. Using the NJSA doesn't rely on one person's or the court's judgment, but requires the active participation of all parties. Using one of the judicial remedies allows modification to proceed, but only for proscribed reasons and it requires court involvement, which can be time-consuming and expensive. Finally, changing the definition of "income" is easy, but a very limited remedy.

C. Possible Complications.

There are three significant possible complications. First, not everyone may agree to the proposed change. In this case, the party seeking modification can use one of the court-authorized procedures. But they are limited in scope, and could result in a legal battle if one of the nonparticipating parties decides to formally object.

Second, the trustee may not participate, or may not act in the way that beneficiaries intended even after the modification is complete. There are very good reasons for such reticence: as fiduciaries, trustees are subjected to liability, and have in fact been sued, for almost everything. And for those acting as trustees or representing them, a healthy skepticism is appropriate. The way to overcome such skepticism is to ensure that the trustee is indemnified and held harmless for participating in the modification and for acting under it.

Finally, often the biggest challenge is avoiding the accidental creating of a taxable gift following modification. Although the tax consequences of modification are beyond the scope of these materials, in general if a trust beneficiary agrees to a modification, the result of which is a diminution in value of his or her interest, he or she probably has made a taxable gift to the beneficiary whose interest has increased in value as a result. To take a slightly unrealistic example, assume an elderly woman with a five-year life expectancy is entitled to $10,000 per year from a trust. At her death, the trust property passes to her daughter. Knowing that her mother needs an extra $10,000 per year for living expenses, the daughter agrees to a NJSA under which her mother's distribution increases to $20,000. By not objecting to this increase, it can be argued that the daughter made a gift of $10,000 per year for five years, reduced to present value, to her mother. Further, because it's not a present interest gift, it can't be offset by the daughter's annual exclusion amount.

Because there is no Oregon gift tax, and because the federal estate and gift tax exemption amount is so high, it may be a nonissue. Further, because the trustee has to agree to the modification as well, it could be argued that it is not a gift at all. Nevertheless, this issue should always be considered when contemplating a modification.

II. NONJUDICIAL SETTLEMENT AGREEMENTS.

Perhaps the most common way of modifying an irrevocable trust in Oregon is to pursue a NJSA under ORS 130.045. It is a relatively easy procedure, but there are several issues that can arise.

A. Generally.

ORS 130.045 (3)(a) states that "interested persons" may enter into a NJSA with respect to any matter involving a trust. However, a NJSA is valid only to the extent the agreement (a) does not violate a material purpose of the trust; and (b) includes terms and conditions that could be properly approved by the court.

Although the statute refers to any matter involving a trust, ORS 130.045 (5) provides a nonexclusive list of matters that may be resolved by a NJSA:

(a) The interpretation or construction of the terms of the trust or other writings that affect the trust;

(b) The approval of a trustee's report or accounting;

(c) Direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power;

(d) The resignation or appointment of a trustee or cotrustee and the determination of a trustee's compensation;

(e) Transfer of a trust's principal place of administration;

(f) Liability of a trustee for an action or failure to act relating to the trust;

(g) Determining classes of creditors, beneficiaries, heirs, next of kin or other persons;

(h) Resolving disputes arising out of the administration or distribution of the trust; or

(i) Modifying the terms of the trust, including extending or reducing the period during which the trust operates.

B. Who has to Participate?

To begin with, we have to define "interested persons." Under ORS 130.145(1), "interested persons" means: (a) any settlor of a trust who is living; (b) all qualified beneficiaries; (c) any acting trustee of the trust; and (d) the Attorney General if the trust is a charitable trust.

Under ORS 130.145(2), if the trust or a portion of the trust is a charitable trust and is irrevocable, and the settlor retains a power to change the beneficiaries of the charitable trust during the settlor's lifetime or upon the settlor's death, the Attorney General shall be substituted as the sole interested person to represent all charitable trust beneficiaries whose beneficial interests are subject to the settlor's retained power. This provision would come into play, for example, when the settlor created a charitable remainder trust for her lifetime benefit and retained the right to designate the charitable remainder beneficiary.

The terms "qualified beneficiaries" and "charitable trust" are defined in ORS 130.010 (14) and 130.170 (1), respectively.

It is possible that one or more interested persons are minors, incapacitated persons or simply not reachable for some reason. In this case a representative may be able to agree on that interested person's behalf. See Section IV, below.

C. To File or Not to File.

The parties to a NJSA must decide whether or not to file with the court. If the NJSA isn't filed with the court, ORS 130.045 (3)(b) provides that "the agreement is binding on all parties to the agreement." On the other hand, if the NJSA is filed with the court, ORS 130.045 (3)(b) provides that the agreement is binding as provided in subsections (6) and (7) (discussed below) unless, after the filing of objections and a hearing, the court does not approve the agreement. If the court does not approve the agreement, the agreement is not binding on any beneficiary or party to the agreement.

ORS 130.045 (6)(a) provides that any interested person may file a NJSA, or a memorandum summarizing it, with the circuit court for any county where trust assets are located or where the trustee administers the trust. Within five days after the filing of a NJSA or memorandum, the person making the filing must serve a notice of the filing and a copy of the NJSA or memorandum on each beneficiary of the trust whose address is known at the time of the filing and who is not a party to the agreement. Service must be made in the form and following the process described in ORS 130.045 (6)(c) and (d). If no objections are filed with the court within 60 days after the filing of the agreement or memorandum, the agreement is effective and binding on all beneficiaries who received notice and all beneficiaries who waived notice.

On the other hand, if objections are filed with the court within 60 days after the filing, ORS 130.045 (7)(a) provides that the court shall fix a time and place for a hearing. The person filing the objections must serve a copy of the objections on all beneficiaries who are parties to the agreement and all beneficiaries who received notice under subsection (6), and give notice to those persons of the time and place fixed by the court for a hearing at least ten days in advance.

The court shall approve a NJSA after a hearing upon objections unless:

- It does not reflect the signatures of all required persons;
- It is not authorized by ORS 130.045; or
- Its approval would not be equitable to beneficiaries who are not interested persons and who are not parties to the agreement.

A NJSA approved by the court after a hearing is binding on all beneficiaries and parties to it. Finally, beneficiaries entitled to notice may waive it.

As this description makes clear, a NJSA filed with the court can be used to bind parties who are not "interested persons" if those parties are given notice and the opportunity to object, whereas a NJSA that is not filed with the court binds only signatories to the agreement.

> **Open Issue:** Does "interested persons" in the statute mean all interested persons? Assume that Mom is the settlor and her three daughters are all the qualified beneficiaries. Mom wants to modify an irrevocable trust she's created, and two of the daughters agree. The third simply won't respond; she's not objecting, she's just not communicating at all (not an uncommon situation). If the third daughter doesn't participate, does an agreement signed by the other three parties qualify as a NJSA? If it does, then Mom could get the other two daughters to sign the agreement, file it with the court and give notice to the third daughter. If the third daughter fails to timely object, then she would be bound. On the other hand, if third daughter's failure to sign means the agreement doesn't qualify as a NJSA, then Mom would have to use one of the more expensive court proceedings to modify the trust (described below).

III. OTHER STATUTORY REMEDIES.

Although NJSAs are usually the first form of modification thought of by Oregon lawyers, ORS 130.195 – 215 provide grounds for trusts to be modified or terminated via court proceeding under certain circumstances.

A. The Process.

All of the following modifications must follow the same process. Under ORS 130.195, a proceeding to approve or disapprove a proposed modification or termination under ORS 130.045, 130.200, 130.205, 130.210, 130.215, 130.220 and 130.225, or trust combination or division under ORS 130.230, may be commenced by a trustee or beneficiary. A proceeding to approve or disapprove a proposed modification or termination under ORS 130.200 may be commenced by the settlor. The settlor of a charitable trust may maintain a proceeding to modify the trust under ORS 130.210.

B. Consent.

This provision comes in two parts. Most importantly, ORS 130.200 (1) provides that an irrevocable trust may be modified or terminated with approval of the court upon consent of the settlor and all beneficiaries who are not remote interest beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust. In other words, if the settlor is alive and everyone agrees, the trust gets a complete do-over.

There is an extensive list of the parties who can or must participate:

- The Attorney General must consent to any modification or termination of a charitable trust.
- A settlor's power to consent to a trust's modification or termination may be exercised by:
  - An agent or attorney-in-fact under a power of attorney only to the extent expressly authorized by the terms of the trust or the power of attorney;
  - The settlor's conservator with the approval of the court supervising the conservatorship if an agent or attorney-in-fact is not authorized by the terms of the trust or a power of attorney; or
  - The settlor's guardian with the approval of the court supervising the guardianship if an agent or attorney-in-fact is not authorized by the terms of the trust or a power of attorney and a conservator has not been appointed.

Even if the settlor is not alive, all is not lost. Under ORS 130.200 (2), an irrevocable trust "may be terminated upon consent of all beneficiaries who are not remote interest beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust." Again, the Attorney General must consent to any modification or termination of a charitable trust.

If the settlor is not alive, there is the hurdle that the modification or termination cannot violate a material purpose of the trust. And a spendthrift provision is rebuttably presumed to constitute a material purpose of the trust. This means that the moving party must overcome the presumption and prove that the spendthrift clause was not material.

> **Note:** The presumption that a spendthrift provision does constitute a material purpose is an Oregon modification to the Uniform Trust Code, which presumes that a spendthrift provision does not constitute a material purpose.

Upon termination of a trust under either subsection, the trustee shall distribute the trust property as agreed to by the beneficiaries and, in the case of a charitable trust requiring the Attorney General's consent, as agreed to by the Attorney General.

The court can approve a proposed modification or termination without the consent of all beneficiaries who are not remote interest beneficiaries if the court finds that: (1) if all beneficiaries who are not remote interest beneficiaries had consented, the trust could have been modified or terminated under this section; and (2) the interests of any beneficiary who does not consent will be adequately protected.

C. Unanticipated Circumstances.

Under 130.205, the court may modify the administrative or dispositive terms of a trust or terminate the trust if it furthers the purposes of the trust and the modification or termination is requested by reason of circumstances not anticipated by the settlor. To the extent practicable, the modification must be made in accordance with the settlor's probable intention.

Further, the court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful, or would impair the trust's administration.

Finally, a trustee may terminate a trust if:

- Termination is appropriate by reason of circumstances not anticipated by the settlor;
- Termination will not be inconsistent with the material purposes of the trust;

- All qualified beneficiaries have consented to the termination;
- The trustee is not a beneficiary of the trust and has no duty of support for any beneficiary of the trust; and
- In the case of a charitable trust, the Attorney General has consented to the termination.

Upon termination of a trust under this section, the trustee shall distribute the trust property in a manner consistent with the purposes of the trust.

D. Cy Pres.

ORS 130.210 provides that, if a particular charitable purpose of a trust becomes unlawful, impracticable, impossible to achieve or wasteful, the trust does not fail (in whole or in part), the trust property does not revert to the settlor or the settlor's successors in interest, and the court may apply cy pres to modify or terminate the trust by directing that the trust property be applied or distributed, in whole or in part, in a manner consistent with the settlor's charitable purposes.

Note that this relief is not available if a provision in the terms of a charitable trust would result in distribution of the trust property to a noncharitable beneficiary, and if, when the provision takes effect, the trust property is to revert to the settlor and the settlor is still living, or fewer than 50 years have elapsed since the date of the trust's creation.

E. Uneconomic Trust.

ORS 130.215 provides that, after notice to the qualified beneficiaries, a trustee may terminate a trust if the trustee concludes that the value of the trust property is insufficient to justify the cost of administration. However, a trustee may not terminate a trust under this section if the trustee is a qualified beneficiary of the trust or has a duty of support for a qualified beneficiary of the trust.

Further the court may modify or terminate a trust, or remove the trustee and appoint a different trustee, if the court finds that the value of the trust property is insufficient to justify the cost of administration.
Upon termination of a trust under this section, the trustee shall distribute the trust property in a manner consistent with the purposes of the trust. This section does not apply to an easement for conservation or preservation.

F. Correcting Mistakes.

Under 130.220, the court may reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if the person requesting reformation proves by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.

This can be a particularly useful provision, with the caveat that proving a mistake by clear and convincing evidence often involves an admission by the drafting attorney of a scrivener's error.

G. Achieving Tax Objectives.

Under ORS 130.225, the court may modify the terms of a trust to achieve the settlor's tax objectives if the modification is not contrary to the settlor's probable intention. The court may provide that the modification has retroactive effect.

H. Catch-All.

In addition to all the preceding remedies, ORS 130.195 provides a trust terminates:

- To the extent the trust is revoked or expires pursuant to the terms of the trust;
- If no purpose of the trust remains to be achieved; or
- To the extent one or more of the purposes of the trust have become unlawful, contrary to public policy or impossible to achieve.

IV. REPRESENTATION.

As these materials have shown, consent by beneficiaries is either helpful or necessary to a modification or termination (depending upon the statutory framework used). ORS 130.100 -120 provides the means in certain circumstances for one person to represent another person in a modification or termination.

In general, ORS 130.100 provides that notice to a person who may represent and bind another person under ORS 130.100 to 130.120 has the same effect as if notice were given directly to the other person, and the consent of a person who may represent and bind another person under ORS 130.100 to 130.120 is binding on the person represented unless the person represented objects to the representation before the consent would otherwise have become effective. There are a few caveats to this rule:

- Notice to a representative must comply with ORS 130.035 (4);

- Except as otherwise provided in ORS 130.200 and 130.505, a person who is authorized to represent a financially incapable settlor under ORS 130.100 to 130.120 may receive notice and give binding consent on the settlor's behalf; and
- A settlor may not represent and bind a beneficiary under ORS 130.100 to 130.120 with respect to the termination or modification of an irrevocable trust under ORS 130.200 (1) (the termination by consent provision).

Further, and most importantly, under all of the following sections, a person cannot represent another if there is a conflict of interest between them with respect to the particular matter at issue.

A. Holders of Testamentary Power of Appointment. Under ORS 130.105, the holder of a testamentary power of appointment may represent and bind persons whose interests are subject to the power as permissible appointees, as takers in default or by other reason.

B. Parents and Fiduciaries. ORS 130.110 provides that: a representative must comply with ORS 130.035 (4);

- a conservator may represent and bind the estate that the conservator controls;
- an agent having authority to act with respect to the particular question or dispute may represent and bind the principal;
- a trustee may represent and bind the beneficiaries of the trust; a personal representative of a decedent's estate may represent and bind persons interested in the estate; and
- A parent may represent and bind the parent's minor or unborn child if a conservator for the child has not been appointed.

C. Substantially Identical Interests. Under ORS 130.115, unless otherwise represented, a minor, financially incapable individual or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable, may be represented by and bound by another person having a substantially identical interest with respect to the particular question or dispute.

D. Special Representative. Sometimes none of the statutes above apply to a given situation. In this case, ORS 130.120 states that, if the court determines that the interest of a person is not represented under ORS 130.100 to 130.120, or that the otherwise available representation might be inadequate, the court may appoint a special representative to receive notice, give consent and otherwise represent, bind and act on behalf of a minor, financially incapable individual or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable. Such a "special representative" may represent several persons or interests, if the interests of the persons represented do not conflict.

A special representative may act on behalf of the individual represented with respect to any matter that the court has authorized, whether or not a judicial proceeding concerning the trust is pending.

In making decisions, a special representative may consider general benefit accruing to the living members of the individual's family.

There are requirements for qualifying as a special representative. He or she must have appropriate skills and experience necessary to adequately represent the individual in the matter. Further, he or she may not have an interest in the subject trust, and may not be related to a personal representative of an estate with an interest in the trust, or to a trustee, beneficiary or other person with an interest in the trust.

A person requesting the appointment of a special representative must file a petition with the court describing the proposed special representative, the need for a special representative, the qualifications of the special representative, the person or persons who will be represented, the actions that the special representative will take and the approximate date or event when the authority of the special representative will terminate. The person seeking to serve as special representative must file a consent to serve. After completing his or her responsibilities, the special representative petitions the court for an order discharging the special representative. Upon order of the court, the special representative is discharged from any further responsibility with respect to the trust.

Finally, a special representative is entitled to reasonable compensation for services. The trustee shall pay compensation to the special representative from the principal of the trust that is attributable to those beneficiaries who are represented. If the beneficiaries who are represented do not have principal that is attributable to them, compensation is an administrative expense of the trust.

V. POWER TO ADJUST AND CONVERSION TO UNITRUST.

Although not technically a modification, choosing an alternate way to determine trust accounting income under Uniform Principal and Income Act ("UPIA") can resolve many beneficiary disputes.

A. Conversion to Unitrust

Although Oregon adopted the UPIA, one of the most significant developments in the area of principal and income acts is not a feature of the UPIA at all. Oregon includes in its principal and income act (ORS §129.225) the power of a trustee to release the power to make adjustments between principal and income (discussed below) and instead convert the trust to a unitrust. Following such a conversion, the trustee continues to make regular distributions under the terms of the trust; however, all provisions relating to distribution of income are instead construed to refer to an annual unitrust distribution of 4% the fair market value of trust assets, averaged over the preceding calendar years (or, if less, the period during which the trust has been in existence).

Once the trust has been converted to a unitrust, the trustee must invest and manage trust assets under the Prudent Investor Act. Oregon provides an ordering structure for distributions, under which they are deemed to be made first from net income, as that amount would be determined if the trust were not a unitrust, then from short-term capital gains, then from long-term capital gains and finally from trust principal. This creates a sort of "worst in, first out" distribution scheme for the unitrust beneficiary, since the assets with the worst characterization from a tax perspective are deemed to be distributed first.

Under ORS §129.225(2)(b), a trustee wanting to convert to a unitrust must give 60 days' notice to enumerated beneficiaries, disclosing the intent to convert and the effect of the conversion. If a beneficiary objects within 60 days of notification, the trustee may not convert. The trustee also has the option to petition the court for an order to convert to a unitrust. ORS §129.225(6) lists the circumstances under which a trustee may not exercise the power to convert to a unitrust.

There are drawbacks to a unitrust conversion. As at least one commentator has pointed out, [1] a unitrust amount of 4% could erode the trust principal over time. Further, using the unitrust approach may incur additional cost and delay if court filing or approval is required for opting in or opting out. Regardless of whether the adjustment power or the unitrust conversion is used, the trustee must have a well-reasoned approach in determining the reasons for the technique chosen, and in the case of the adjustment power, the amount used, to avoid any imputation of favoring one beneficiary over another. [2]

In a New York case, [3] the grantor created a trust under which the spouse received income during her lifetime and his children (two sons and two daughters) would receive the principal upon the death of the spouse. The trust provided that the spouse was entitled to receive the greater of $40,000 or the total income of the trust. As named successor trustees, the grantor's sons became trustees in 1997. From 1997 until 2001, the spouse received an average of $190,000 in trust income per year. In 2003, the trustees elected to change the trust to a unitrust retroactively. As a result of the unitrust election, the spouse received approximately $70,000 per year. Additionally, the spouse owed money to the trust as a result of the retroactivity of the unitrust election. The spouse sought to have the unitrust election voided.

In *In re Heller*, the court held that the trustees were not prohibited from changing the trust to a unitrust merely because the trustees are interested beneficiaries of the trust, especially considering that the trustees were only two of the four beneficiaries. [4] The court also held that the statute that granted the trustees the power to convert a trust to a unitrust included language that foresaw retroactive election of unitrusts. Therefore, the trustees' retroactive election was a valid exercise of trustee powers. [5] Note, however, that New York changed the law in 2008 to limit the retroactivity of the unitrust election.

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[1] Moore & DeHaan, Trustee's Choice: The If, How and When of the UPIA, 153 Trusts & Estates 41, 47 (May 2014).

[2] Id.

[3] In re Heller, 849 N.E.2d 262 (N.Y. Ct. App. 2006).

[4] Id. See also In re Heller, 23 A.D.3d 61, 800 N.Y.S.2d 207 (App. Div., 2d Dept. 2005) (trial court stated that statute granting election of unitrust status does not prohibit, per se, election by interested trustee; rather, court must consider facts and circumstances, including (i) nature, purpose and expected duration of trust, (ii) intent of grantor, (iii) identity and circumstances of beneficiaries, (iv) need for liquidity, (v) regularity of payment, and (vi) preservation and appreciation of capital).

[5] In re Heller, 849 N.E.2d 262 (reversing trial court's determination that trustees could not elect unitrust status retroactively).

In another New York case [6], the New York Surrogate's Court approved the trustee's unitrust election, retroactive to the beginning of the year in which the election was requested, because the unitrust would provide the sole income beneficiary with greater annual income for her current health care needs without depleting the trust principal.

B. Trustee's Power to Adjust

A significant change made by the UPIA is the power to adjust. UPIA §104(a) (ORS §129.215) provides as follows:

> A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in [UPIA] §103(a) [ORS §129.210], that the trustee is unable to comply with [UPIA] §103(b) [ORS §129.210]. [7]

The purpose of this adjustment power is "to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income." [8] The adjustment power is available (subject to other restrictions) if three conditions are met: (1) the trustee is managing trust assets under the prudent investor rule; (2) the trust instrument expresses the current beneficiary's rights in terms of traditional income; and (3) the trustee cannot exercise her duty of impartiality after applying the provisions of the UPIA or the trust or will instrument. [9]

The intent behind this adjustment power is not to "empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled." [10] Rather, a trustee may use the adjustment power to compensate for those times when "the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule." [11] Further, although this adjustment power eliminates the trustee's need to be concerned about the income component of the trust's investment portfolio, the trustee still must "determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio's liquidity as a whole to make that distribution." [12]

1. Factors in Determining Whether to Adjust

UPIA §104(b) (ORS §129.215(2)) provides the following list of factors a trustee must consider when deciding whether to adjust between income and principal:

- the nature, purpose and expected duration of the trust;
- the intent of the settlor;
- the identity and circumstances of the beneficiaries;
- the needs for liquidity, regularity of income and preservation and appreciation of capital;
- the trust assets, and the extent to which the trust assets consist of financial assets, interests in closely held businesses or personal or real property, the extent to which an asset is used by a beneficiary and whether an asset was purchased by the trustee or received from the settlor (notice that this last factor contradicts the Prudent Investor Act, which requires the trustee to assess the appropriateness of each asset, whether received from the settlor);
- the net amount allocated to income under other sections of the Act and the increase or decrease in the value of principal;

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[6] In re Moore, 41 Misc. 3d 687, 971 N.Y.S.2d 419 (Sur. Ct. 2013).
[7] UPIA §104(a) (Unif. Law Comm'n 2008).
[8] UPIA §104 cmt. (Unif. Law Comm'n 2008). See Estate of Morse, Index No. 83862 (N.Y. Sur. Ct. 2006) (trustee appropriately exercised power to adjust between income and remainder beneficiaries).
[9] Id.
[10] UPIA §104 cmt. (Unif. Law Comm'n 2008). The comment to UPIA §104 states that the first condition of this test is generally satisfied in virtually all states, unless the state provides a statutory list of assets in which a trustee may invest. The second condition is satisfied if the terms of the trust require the trustee (i) to distribute all trust income at regular intervals, (ii) to distribute all trust income among to a class of beneficiaries, the amount of which is left to the discretion of the trustee, or (iii) to distribute to the beneficiary the greater of an annuity amount or a unitrust amount. The third condition is satisfied if the trustee, after determining whether the terms of the trust manifest a clear intention to favor one or more of the beneficiaries, concludes that she is unable to administer the trust impartially or to achieve a degree of partiality required or permitted. Id.
[11] Id. In re Orpheus Trust, 124 Nev. 170, 179 P.3d 562 (2008) (stating that purpose of power to make adjustment "is to permit adjustments between principal and income in order to take advantage of investments which may yield a substantial appreciation of principal value while yielding relatively little income in the conventional sense, or, conversely, an investment which yields a relatively high conventional income might yield a disproportionately low possibility of appreciation principal").
12 UPIA §104 cmt. (Unif. Law Comm'n 2008).

- the extent to which (if any) the trust allows the trustee to invade principal or accumulate income, and the extent to which the trustee has exercised this power;
- the actual and anticipated effects of economic conditions and inflation or deflation on principal and income; and
- the anticipated tax consequences of an adjustment. [13]

2. Prohibitions on Adjustment Power

Not all trustees can exercise the power to adjust. Under UPIA §104(c) (ORS §129.215(3)), a trustee may not make an adjustment if:

- the adjustment would disqualify the trust for marital deduction treatment, or that would fail to qualify a trust for the gift tax exclusion;
- the adjustment changes the amount payable to a beneficiary as a fixed annuity or a fraction of trust assets;
- the adjustment is made from any amount that is permanently set aside for charitable purposes under a will or trust unless both income and principal are set aside;
- the adjustment power is the sole reason that the trustee would become the owner of the trust property for income tax purposes;
- holding the adjustment power causes any part of the trust assets to be included in the taxable estate of an individual who has the power to remove or appoint a trustee;
- the trustee is a trust beneficiary; or
- the trustee would benefit, directly or indirectly, from the adjustment. [14]

Note that these limitations are not entirely clear. For example, the comment to UPIA §104 seems to indicate that UPIA §104(c)(3) governs charitable remainder trusts, including the net-income-with-makeup charitable remainder unitrust, under which the income beneficiary receives the lesser of trust accounting income or the unitrust amount for any given year. This comment suggests that, in certain circumstances, a trustee may be able to adjust income for such trusts. However, UPIA §104(c)(4) states that no adjustment is available for any amounts permanently set aside for charitable purposes. A cautious reading of these two provisions would indicate that an adjustment is not available for net-income-with-makeup charitable remainder unitrusts unless specifically authorized by the terms of the trust. If drafted incorrectly, however, such an adjustment clause could disqualify the trust as a charitable remainder trust under federal tax law.

3. Factors to Consider When Using the Adjustment Power

The key element in using the adjustment power is to determine the appropriate level or range of income for the income beneficiary. Once the trustee has determined the range of income, the trustee must determine whether and to what extent to exercise her adjustment power. The UPIA provides the trustee broad discretion in selecting the criteria to determine whether and to what extent to exercise the adjustment power when attempting to achieve impartiality or a predetermined degree of partiality between the beneficiaries. [15]

Once having made the decision to adjust, the trustee must decide how to calculate the amount of adjustment. One method is to analyze the amount of income, on a percentage basis, that would be generated by a balanced investment portfolio. [16] For example, if a hypothetical portfolio built on 50% equities and 50% fixed income would generate 3.2% income, then the trustee can adjust between principal and income in the trustee's actual portfolio so that 3.2% of that actual portfolio is classified as income. This percentage could be calculated using a "floor" and "ceiling" (that is, a fixed percentage range of the prior year's income on the hypothetical portfolio) or a rolling three year average of the return from the hypothetical portfolio. The trustee also would need to determine whether to apply this at the beginning or end of the year. And, of course, the adjustment percentage should be recalculated each year. [17]

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[13] UPIA §104(b) (Unif. Law Comm'n 2008).
[14] UPIA §104(c) (Unif. Law Comm'n 2008).
[15] UPIA §105 cmt. (Unif. Law Comm'n 2008).
[16] Moore & DeHaan, Trustee's Choice: The If, How and When of the UPIA, 153 Trusts & Estates 41, 46 (May 2014).
[17] Id. at 46.

Importantly, however, a trustee should remember that the adjustment power is an investment tool, not a technique to benefit one beneficiary over another. This point was made in an Oklahoma case, [18] in which a trustee was found liable for using the adjustment power to increase distributions to the income beneficiary even though the trustee already was investing primarily to generate income rather than long-term growth. In this case, the trust investments, which were primarily invested in municipal bond funds, already favored the income beneficiary over the remainder beneficiary. When the trustee modified the trust's asset allocation to generate more income for the income beneficiary by investing in variable prepaid forward contracts, it effectively used its power to adjust to transfer more income to the income beneficiary, which was a breach of its duty to be impartial. [19]

The following are examples of when a trustee may consider using the adjustment power:

> Example: T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under UPIA §406, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T deems relevant, T may transfer part of the interest to principal. [20]

> Example: T is the trustee of a trust for the settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of $600,000 and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of $900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed. T allocates 10% of the distribution to income under UPIA §409(c). The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with UPIA §103(b) include the following: (i) the total return from all of the trust's assets, those owned directly as well as its interest in the IRA; (ii) the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal; and (iii) the extent to which the income beneficiary will be subject to income tax on the amount that T distributes to the income beneficiary. [21]

> Example: T is the trustee of a trust whose portfolio includes an interest in a mutual fund sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by $2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under UPIA §501(1) and the other one-half from principal under UPIA §502(a)(1). After considering the total return from the portfolio as a whole and other relevant factors described in UPIA §104(b), T may exercise its power to adjust by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income. [22]

An adjustment may be made at the beginning of an accounting period or retroactively. [23] At least one court has held that the adjustment can be made retroactively for at least a one-year period. [24] No inference of abuse is drawn if a trustee changes the method or criteria for making adjustments. A trustee also may adopt, and thereafter amend, policies that provide criteria or factors to determine when deciding whether and to what extent to use the adjustment power. The policies also may assist the trustee in the event of a lawsuit because the policies provide a manuscript of the trustee's determination to use the adjustment power.

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[18] In re Burford, No. PT 2006-013 (Okla. Dist. Ct. Oct. 9, 2012) (cited in Cohen & Smith, A Trustee's Guide to the Uniform Principal and Income Act, 153 Tr. & Est. 49, 50 (May 2014)).
[19] In re Burford, No. PT 2006-013.
[20] UPIA §104 cmt. Ex. 2 (Unif. Law Comm'n 2008).
[21] UPIA §104 cmt. Ex. 5 (Unif. Law Comm'n 2008).
[22] UPIA §104 cmt. Ex. 7 (Unif. Law Comm'n 2008).
[23] UPIA §105 cmt. (Unif. Law Comm'n).
[24] In re Orpheus Trust, 124 Nev. 170, 179 P.3d 562
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