Message From The Editor

In order to ensure that the Trusts and Estates Section continues to provide a Newsletter of general interest to its membership, articles concerning timely topics are always welcome. In the event section members may be interested in submitting an article or a suggestion regarding a topic on estate planning and administration, you are encouraged to contact Mark Ferguson, the incoming newsletter editor for 1999/2000, at (703) 790-8440. Hopefully, with the assistance of our vast and varied membership, the Newsletter will continue to provide articles of interest to its membership on a more frequent basis.

For those of you who have recently joined the ranks of the Trusts and Estate Section, it is anticipated that a dedicated issue of the Virginia Lawyer focusing on trust and estate issues will published in December of 1999.

As with any professional organization, the Trust and Estates Section depends largely on the literary contributions of its membership in publishing the Newsletter. However, if you have an interest in expanding your participation in the Trust and Estate Section, we would welcome your input and assistance. Please feel free to contact any of the members of the Board of Governors (listed on the back cover) with your comments or suggestions. Your input is very important in ensuring a viable Newsletter.

Regards,

W. William Gust

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The Trusts and Estates Newsletter is published by the Virginia State Bar Section on Trusts and Estates for its members to provide information to attorneys practicing in these areas. Statements, expressions of opinion, or comments appearing herein are those of the editors or contributors and not necessarily those of the Virginia State Bar or the Section on Trusts and Estates.
One of the more frustrating topics attorneys discuss with clients involves a client appointing a nonresident as executor of his will. Although the 1996 General Assembly revised Virginia Code § 26-59, which, among other things, allows for the appointment of a nonresident as a fiduciary of a Virginia decedent's estate or testamentary trust, Virginia law still places a significant barrier to a nonresident serving as a fiduciary: the nonresident either must (i) post bond with surety or (ii) have a Virginia resident qualify as co-executor or co-trustee. Upon learning of this burden, the client typically chooses not to charge his estate with the extra cost of a surety bond and either nominates a Virginia resident in his will to serve as co-fiduciary with the nonresident or provides in the will that the nonresident fiduciary may make such an appointment. In either case the testator's desire to have a nonresident fiduciary serve alone, without additional cost, is thwarted. If the testator wants surety on the bond of his nonresident fiduciary, he could simply not waive the requirement of surety in his will.

Although perhaps not as eye-catching as the right to life, liberty, and the pursuit of happiness, one judge described the ability to choose one's executors as follows:

"The right [is] a fundamental property right of a competent adult having testamentary capacity. . . . It is difficult to distinguish the right of a party to do business with whom they choose in their lifetime from their right to designate the same parties to handle their affairs after death." The Supreme Court of Virginia has voiced a similar opinion:

"The selection of an executor is an intensely personal matter. No business transaction which men must face is more so, and not by remotest indirection should the State trench upon this privilege except for cogent reasons." Policy Reasons Favoring Virginia Fiduciaries

What public policy is served by Virginia's restrictive laws concerning nonresident fiduciaries? The most prevalent answer is that the laws protect Virginia banks and trust companies against foreign competition. What with the recent rash of bank mergers, Virginia's laws will protect banks with home offices not in Virginia but in North Carolina and Georgia. This public policy should not be considered a strong one:

"[T]rusts are not created for the benefit of the trustees. The interest of a testator in disposing of his estate, and the interests of the beneficiaries, are far more important than those of the trust companies of the state in which the testator happens to be domiciled when he dies."

In its most recent session, the General Assembly recognized that the landscape of corporate trustees in Virginia had changed and enacted the Multistate Trust Institutions Act (the "Act"). The Act allows non-Virginia institutions, including national banks with a home state other than Virginia, to transact trust business in Virginia. The non-Virginia institution (i) must be registered to do business in Virginia, and (ii) must file with the State Corporation Commission the application or notice it files with its home-state regulator. The act also contains reciprocity language which provides that the non-Virginia institution may establish or acquire a trust office in Virginia only if its home state permits Virginia institutions to do likewise in that state. The reciprocity requirement poses a significant barrier to a non-Virginia institution that wants to operate a trust business in Virginia.

In addition to the interests of Virginia corporate fiduciaries, what about the interests of Virginia beneficiaries and creditors? Won't those parties be better served if a Virginia resident serves as fiduciary? The unstated proposition underlying these questions is that a Virginia court in Accomac County can supervise an estate's or trust's administration in
Wise County better than can a foreign court, a proposition with which I doubt many people, much less many non-Virginia courts, would agree. Besides, because of full faith and credit, the prevalence of long-arm statutes and the ability to serve process on defendants who live far outside Virginia’s borders, a creditor’s rights are not weakened if a non-resident trustee serves.

To assuage the fears of their citizens, some states have adopted statutes such as the following:

“By accepting the trusteeship of a trust of which the principal place of administration is in this state, or by moving the principal place of administration of a trust to this state, the trustee submits personally to the jurisdiction of the courts of this state.

In those states which have adopted the Uniform Probate Code (U.P.C.) provision, a trustee, irrespective of his residence, may be subject to in personam jurisdiction in the forum in which the trust property is located. Virginia’s law currently requires a nonresident to appoint (i) the clerk for the city or county where he qualified or (ii) a Virginia resident as his agent to receive service of process, and thus clearly protects the interests of creditors and beneficiaries.

From a practical standpoint, favoring a Virginia resident who lives six hours away from the courthouse over a nonresident who lives only ten minutes away seems ludicrous. If a long-time family advisor lives just over the state line in Bristol, Tennessee, for example, should that fact by itself disqualify him from serving the client’s family as a sole fiduciary?

The Revocable Living Trust Solution

Interestingly, a Virginia testator can solve the problem caused by the out-of-state residency of his individual fiduciary by having his residuary estate pour over to a trust he established during his lifetime. New Virginia Code § 64.1-73.1, which replaces § 64.1-73, specifically permits a nonresident individual to serve as trustee of such a trust, with the individual’s residency determined when the distribution is made to the trust. Before he can receive the estate’s assets, however, the nonresident individual trustee must file a consent form that service of process in any action against him may be made by service upon a Virginia resident. No bond with surety or further requirement will be necessary.

A foreign corporate trustee must be “authorized to do a trust business in this Commonwealth” to be a trustee of such a trust. Other states, most recently Missouri, have amended their laws to recognize that banks, trust companies, or national banking associations in good standing, who have taken over local banks or trust companies, are authorized to act as fiduciaries in Missouri. The foreign corporate fiduciary may act in Missouri “without the necessity of complying with any [Missouri] law relating to the licensing of foreign banking corporations... or relating to the qualifications of foreign corporations to do business in [Missouri].”

Call for Reform

Much like the NCAA committee that is currently investigating whether its own rules prohibiting college athletes from earning money “do in fact make sense,” the General Assembly should revisit Virginia Code § 26-59 to see if it still makes sense. Having just passed Va. Code § 64.1-73.1 that allows a nonresident trustee of an inter vivos trust to receive a decedent’s residuary estate from the executor, the General Assembly should take the small step of removing the surety cost barrier for a nonresident executor or testamentary trustee. The General Assembly also should consider refining the Multistate Trust Institutions Act to permit foreign banks and trust companies to serve as fiduciaries in Virginia without the reciprocity requirement, which merely hinders competition. These two changes would bring the administration of estates and testamentary trusts more closely in line with that of inter vivos trusts, would update Virginia laws that are outdated, and, most importantly, would give testators free choice in the selection of their fiduciaries.

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ENDNOTES


9Id.


11Id. at § 362.600.1(2).
In a development that many probate practitioners felt had been a long time coming, the United States Supreme Court has agreed to resolve a question that has divided the Circuits: Whether a disclaimer by an estate beneficiary can prevent a federal tax lien from attaching to property which the beneficiary otherwise would inherit. The case that brings this issue before the Supreme Court is Drye Family 1995 Trust v. United States, 152 F.3d 892 (8th Cir. 1998). The Supreme Court granted certiorari on April 19, 1999 (67 U.S.L.W. 3633).

In Drye, an Arkansas resident died intestate on August 4, 1994, leaving an estate worth approximately $236,000. The intestate was survived by her son and sole heir-at-law and his daughter. On the date of his mother’s death, the son was insolvent and owed the United States approximately $325,000 in assessed income taxes. On February 4, 1995, the son filed a disclaimer of all his interest in his mother’s estate. On or about the same day, his daughter created the Drye Family 1995 Trust and funded it with the interest in the estate that passed to her by virtue of the son’s disclaimer. The Trust permitted discretionary distributions to the son, his wife, and his daughter.

The Circuit Court noted that it was given considerable pause by the son’s “retention of a life estate in the Trust, which was funded in large part if not entirely by the disclaimed property.” Perhaps if the court had focused upon the question of acceptance, it would have decided the case by holding that no valid disclaimer occurred. Under the regulations of Internal Revenue Code section 2518, the acceptance of any consideration for making a disclaimer equates to acceptance of the property and thus prevents a valid disclaimer. An argument could have been constructed based upon the appearance of a prearranged plan in which the son would receive his interest in the Trust in exchange for his disclaimer. This troublesome aspect of the factual situation hopefully will not affect the Supreme Court’s opinion.

The Arkansas Probate Code, like the disclaimer statutes of many states, provides that a disclaimer effected under its provisions creates the legal fiction that the disclaimant predeceased the decedent and that the disclaimer relates back for all purposes to the date of death. Ark. Code Ann. § 28-2-108(a)(1) & (3). The appellants thus contended that the son never had a property interest in his mother’s estate to which federal liens could attach. The government maintained that the federal tax liens attached to the son’s interest in his mother’s estate on the date of her death and that the subsequent disclaimer was ineffective to remove them.

The Eight Circuit agreed with the government’s position that the property interest to which the lien attached was but “right to inherit” from the decedent rather than the actual assets formerly owned by the decedent. The court reasoned that, although a right or an interest — here, the right to inherit — is created by state law, federal law determines whether that interest is property. Code section 6321 creates a lien in favor of the United States upon all “property and rights to property” belonging to any person who has neglected or refused to pay any tax. The Code does not define “property” or “rights to property” for purposes of section 6321. Nevertheless, the court in Drye cited other appellate decisions that have interpreted “property” or “right to property” to mean state-law rights or interests that have pecuniary value and are transferable, even if the applicable state law does not determine such rights to be property. Here the right to inherit under state law was the property interest.

Further, the court reasoned, section 6334 specifically exempts certain property or rights to property from the ambit of section 6321 levy provisions, and section 6334(c) provides that the list of exempt property and rights in section 6334 is exhaustive. Because there is no specific exemption under section 6334 for property or rights to property disclaimed under state law, the court concluded that Congress’s failure to exempt such property evidences its intention to subject disclaimed property to federal levy.

Drye is not without precedent. Numerous decisions from the Eighth Circuit and elsewhere, faced with a variety of fact situations, have similarly concluded that a disclaimer does not avoid a federal tax lien. United States v. Comparato, 22 F.3d 455
(2d Cir. 1994) (purported disclaimer of a vested interest in wrongful death proceeds occurred approximately seven years after the disclaimer period); United States v. Solheim, 953 F.2d 379 (8th Cir. 1992) (disclaimer was untimely and state law had no relation-back language extending to an untimely disclaimer); Tinari v. United States, 78 A.F.T.R.2d (RIA) 96-6381, 96-2 U.S. Tax Cas. (CCH) ¶ 50460 (E.D. Pa. 1996); Estate of Adler, 869 F. Supp. 1021 (E.D.N.Y. 1994) (surviving spouse could not avoid an income tax lien when she attempted to renounce wrongful death proceeds). The Second Circuit Court of Appeals, in Comparato, applied the same reasoning followed by the Eighth Circuit Court of Appeals in Drye, holding that the lack of an exemption in section 6334 for the disclaimed interest was controlling, despite the relation-back theory of the applicable New York state law.

In contrast, the Fifth and Ninth Circuit Courts of Appeals have reached precisely the opposite conclusion. In these circuits, the decisions hold that a disclaimer operates retroactively, pursuant to state law, and thus the disclaimant never acquires a property interest to which a lien can attach. Leggett v. United States, 120 F.3d 592 (5th Cir. 1997) (reversing the Southern District of Texas); Maps v. United States, 15 F.3d 138 (9th Cir. 1994); United States v. McCrackin, 189 F. Supp. 632 (S.D. Ohio 1960).

The court in Leggett considered two possible analyses of the operation of disclaimers under Texas law. Under one view, which the court named the “Transfer Theory,” the intended beneficiary has a vested property right from the moment of death, and the effect of a valid disclaimer is to transfer the property to other beneficiaries. Under the second view, the “Acceptance-Rejection Theory,” property passes at the moment of death into a kind of state of suspension in the decedent’s estate, and thereafter the intended beneficiaries may accept or reject their inheritances. When a beneficiary accepts an inheritance, the law engages in the legal fiction that he owned the property from the moment of death; likewise, upon a proper rejection, the fiction is that the intended beneficiary never acquired the property interest from the decedent. The Fifth Circuit held that Texas courts had adopted the Acceptance-Rejection Theory, and thus Leggett’s timely, valid disclaimer prevented her from ever acquiring a property right to which a federal tax lien could attach. Moreover, the court specifically held that the right of acceptance or rejection was not itself a property right under Texas law. The court reconciled its holding and the decisions of the Second Circuit (Comparato) and the Ninth Circuit (Maps) by reference to the underlying state law: In New York (Comparato), the right to inherit was itself a property interest, while in Texas and Arizona (Maps) it was not. Finally, the court refused to apply an expansive reading of section 6321, suggesting that such an approach was precluded by Congress’s failure to define property more broadly than state law does or to prohibit taxpayers from making disclaimers.

If the Supreme Court holds, as did the court in Leggett, that the right to inherit is not a property interest under state law, and that there is nothing to which a lien can attach if property is disclaimed, then the positions of taxpayers indebted to the United States will vary depending upon state law. In a number of states it has been established by statute or decisional law that a disclaimer prevents the disclaimant’s creditors from reaching the disclaimed property. The cases tend to apply a relation-back doctrine that views the disclaimer as retroactively eliminating the disclaimant’s interest in the property, leaving no interest which can be transferred by the disclaimant. Cal. Prob. Code § 281 (West 1991); Md. Code Ann., [Estates &Trusts] § 9-204(f) (1973); Tompkins State Bank v. Niles, 537 N.E.2d 274 (Ill. 1989); Estate of Hansen, 248 N.E.2d 709 (Ill. App. Ct. 1969); National City Bank v. Oldham, 537 N.E.2d 1193 (Ind. Ct. App. 1989); Frances Slocum Bank & Trust Co. v. Estate of Martin, 666 N.E.2d 411 (Ind. Ct. App. 1996); Baltrusaitis v. Cook, 435 N.W.2d 417 (Mich. Ct. App. 1988); Succession of Neuhauser, 579 So. 2d 437 (La. 1991) (creditor failed to prove renouncing beneficiary either disclaimed with intent to defraud or that the disclaimer caused or increased insolvency); Trew v. Trew, 558 N.W.2d 314 (Neb. App. 1996); Estate of Opatz, 554 N.W.2d 813 (N.D. 1996) (neither judgment lien nor garnishment summons constitutes an “encumbrance” barring a disclaimer); Parks v. Parker, 957 S.W.2d 666 (Tex. App. 1997); Dyer v. Eckols, 808 S.W.2d 531 (Tex. App. 1991); Estate of Goldammer, 405 N.W.2d 693 (Wis. Ct. App. 1987); Abbott v. Willey, 253 Va. 88, 479 S.E.2d 528 (Va. 1997) (After Attorney Willey converted clients’ funds to his personal use, the clients obtained a promissory note obligating both him and his wife Kathleen Willey to make repayment. Willey then committed suicide and, in a case of first impression, the Virginia Supreme Court permitted Mrs. Willey to disclaim insurance proceeds, which then passed for the benefit of her children).
**Estate of Heater v. Department of Public Aid**, 640 N.E.2d 654 (Ill. App. Ct. 1994), in which the court acknowledged that a beneficiary could disclaim to prevent creditors from taking the inheritance, but that a personal representative of a deceased beneficiary could not do so because of the personal representative’s fiduciary duty to all interested persons, including creditors of the deceased.

However, in other states the cases or statutes establish that a disclaimer cannot be used to prevent creditors from reaching the disclaimed property. Fla. Stat. § 689.21(6) (1943) (nontestamentary transfers); Fla. Stat. § 732.801(6) (testamentary transfers) (in either case, a disclaimer is barred if beneficiary is insolvent at time of event giving rise to the right to disclaimer); La. Civ. Code art. 1021 (West 1973) (creditors of an heir who renounces an inheritance can be authorized by the judge to accept the property in the name of the debtor and in his stead); Mass. Gen. Laws ch. 191A, §8(2) (1958) (disclaimer barred if the beneficiary is insolvent at time of attempted disclaimer); Minn. Stat. § 525.532 Subd. 6 (1945) (testamentary); Minn. Stat. § 501B.86 Subd. 6 (1945) (nontestamentary) (in either case, disclaimer is barred if the beneficiary is insolvent); N.J. Rev. Stat. § 3B:9-9(d) (1937) (testamentary); N.J. Rev. Stat. § 46:2E-9(3) (1937) (nontestamentary) (in either case, disclaimer is barred if it is in fraud of creditors); N.C. Gen. Stat. § 31B-4(a)(4) (1943) (disclaimer is barred by sale of the property under judicial sale made before the renunciation is effected); N.D. Cent. Code § 30.1-10-01(5) (1943) (disclaimer is barred by sale of the property under judicial sale made before the disclaimer is made); 20 Pa. Cons. Stat. § 6202 (1930) (if a disclaimer is by a fiduciary or attorney-in-fact, a court may authorize the disclaimer only if no prejudice to rights of creditors).

In addition, some courts hold that creditors are not avoided by a disclaimer because such a renunciation is a fraudulent conveyance or a transfer. Stein v. Brown, 480 N.E.2d 1121 (Ohio 1985); Estate of Abesy, 470 N.W.2d 713 (Minn. Ct. App. 1991) (garnishee summons in place at time of attempted disclaimer was a transfer by judicial process, and under Minnesota law, a beneficiary could not disclaim if a transfer by judicial process occurred before the disclaimer). However, close attention is required to the specific language of the applicable statute to determine whether a disclaimer can avoid creditors under state law. For example, the Kansas statute prohibits a disclaimer occurring after “any sale or other disposition . . . pursuant to judicial process.”

470 N.W.2d 713 (Minn. Ct. App. 1991) Abesy, under state law. For example, the Kansas statute under Minnesota law, a beneficiary could not disclaim a fraudulent conveyance or a transfer.

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**In re Chenoweth**, 132 B.R. 161 (Bankr. S.D. Ill. 1991), the court found an attempted disclaimer was an unauthorized post-petition transfer of property that now belonged to the bankruptcy estate and which could be avoided by the bankruptcy trustee under Bankruptcy Code section 549. The court focused on the language of section 541(a)(5)(A) of the Bankruptcy Code which included interests that the debtor “acquires or becomes entitled to acquire” within 180 days after bankruptcy and determined that the debtor was entitled to acquire the interest in the estate. See also In re Lewis, 45 B.R. 27 (Bankr. W.D. Mo. 1984); In re Betz, 84 B.R. 470 (Bankr. N.D. Ohio 1987) (specifically not addressing “bankruptcy law considerations” because Ohio law would treat the disclaimer as a fraudulent conveyance). Arguably, however, a distinction could be made under a relation-back view of the disclaimer that might contravene the disclaiming debtor as never having become “entitled to acquire” the disclaimed property within the meaning of section 541(a)(5)(A) of the Bankruptcy Code.

What about a pre-petition disclaimer? Again, there are differing views. The bankruptcy court in In re Brajkovic, 151 B.R. 402 (Bankr. W.D. Tex. 1993), viewed the execution of a disclaimer as the transfer of a property interest. The debtor was the devisee of an undivided one-half interest in certain Missouri real estate. Six weeks before filing bankruptcy, she disclaimed the property with the result that, under Missouri law, the property passed to her minor children.
The court found that, despite the relation-back concept with regard to the legal title of the real estate after the disclaimer, immediately before the disclaimer the debtor had an interest in the property, albeit an equitable interest, and the court saw the execution of the disclaimer as a pre-petition transfer. See also In re Stevens, 112 B.R. 175 (Bankr. S.D. Tex. 1989), in which the court found that the right to control, deduct or receive a testamentary distribution constitutes an interest in property and that the date the renunciation was executed was the date of transfer. In re Perry, 40 B.R. 811 (Bankr. M.D. Tenn. 1984), involved a decedent’s death on October 21, 1981, the beneficiary’s renunciation of an interest in the decedent’s real estate on July 15, 1982, and the beneficiary’s filing of a Chapter 7 petition on April 20, 1983. The court held that the right to receive a testamentary distribution constituted an interest in property, that the disclaimer was a transfer, that the relation-back concept under Tennessee law did not change the time of the transfer, and that the transfer was fraudulent in that it was made when the debtor was under significant pressure from creditors. The court observed that the debtor had not disclaimer the personal property, which would be exempt in the bankruptcy proceeding.) Thus, it denied discharge because the debtor disclaimed within one year of filing bankruptcy.

On the other hand, in In re Atchison, 925 F.2d 209 (7th Cir. 1991) (Illinois law), cert. denied sub nom. Jones v. Atchison, 502 U.S. 860, 112 S.Ct. 178 (1991), the court held that a beneficiary’s pre-petition disclaimer of a testamentary bequest governed by Illinois law did not constitute a “transfer” which could be avoided by the bankruptcy trustee under Bankruptcy Code section 548(a). Atchison filed for joint bankruptcy less than three months after she disclaimed an inheritance under her father’s will, causing the property to pass to her children. The court found that the relation-back provision of the Illinois disclaimer statute eliminated any interest which Atchison held at the time of the disclaimer and that, absent a federal law to the contrary, a debtor’s interest in property is determined by applicable state law. Similarly, in In re Simpson, 36 F.3d 450 (5th Cir. 1994) (Texas law), the bankruptcy trustee was not permitted to avoid a disclaimer filed one day before filing the bankruptcy petition. The court specifically rejected the reasoning of Brajkovic because it failed to give effect to the state law relation-back concept. Accord, Hoecker v. United Bank of Boulder, 476 F.2d 838 (10th Cir. 1973) (Colorado law).

In summary, the Supreme Court will have to decide whether the phrase “property or rights to property” in section 6321 of the Internal Revenue Code means the inherited property or the right to inherit. Further, if section 6321 refers to the inherited property itself, the Court must decide whether the relation-back concept, which is part of the statutory scheme of many states, works to erase any potential interest that the taxpayer ever had in the disclaimed property, preventing lien attachment. The effect of a ruling in favor of the taxpayer in Drye will be to produce differing results for taxpayers, depending upon the applicable state law, with regard to creditor avoidance through the use of disclaimers. A ruling upholding the government’s position in Drye will provide a predictable, albeit an unfavorable, outcome whenever a proposed beneficiary is subject to creditors’ claims. Although this may seem to provide a uniform result for all taxpayers, in actuality, those taxpayers who can afford to plan in advance will be placed in a better position than those who cannot afford advance planning. In each situation when a taxpayer or debtor sought to avoid creditors through a disclaimer of an interest created by a grantor or testator, the creditors could have been avoided if the interest had never been created. The grantor or testator who is aware that a potential beneficiary is exposed to creditors’ claims can simply omit that beneficiary from the estate plan.

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ESTATE PLANNING FOR COLLECTORS

By
Nicholas Kalis

Your client, while not the sort of rich philanthropist featured in the media, has nevertheless amassed a sizeable collection of one sort or another. How do your counsel him? As an attorney who is also a model railroader I have had occasion to counsel my fellow enthusiasts about estate planning and their collections. Many of the pointers contained herein will also apply to other collectors — simply replace "model railroader" with the hobbyist designation applicable to your client. When you encounter “National Model Railroad Association (NMRA)” replace it with the organization your client knows is well organized in his hobby area. The nuts and bolts approach taken in these lines presumes that you undertake all the normal inquiries you normally take with any client who simply seeks a will and no more, or opts for your full gamut of estate planning services.

Perhaps first of all, I advise my clients to invest in a computer program that allows them to print out a detailed record of what they have acquired. This inventory program should feature fields for entering the acquisition price as well as a current market value estimate of each item in their collection. Your client should be able to find several competing programs offered for sale in the pages of his favorite hobby magazine. A program designed for his particular collection should make it easier to identify each item and reap a maximum sales price. He should make more than one copy of this record and leave a second copy with a friend or other trusted party. These inventory programs also make it easier to sell off items of the collection should your client tire of an item, need to raise cash for other needs or to acquire a different item for his collection. His own copy of the inventory should be kept in a location off-site from where the collection is kept. Of course every significant item in his collection should be clearly labeled and if possible given an identification number matching that assigned to it in his computerized or manual inventory. These tips will serve your client well in case of an insurable loss from fire or theft. Note the word "insurable" — have your client ascertain whether his collection is insured by his current homeowners policy. Some policies place limits on paying out for this type of loss. Should your client discover his current homeowners policy will not insure this sort of loss he will have two options — finding an alternate satisfactory homeowners’ policy or purchasing a policy of the sort advertised in the various publications of the hobbyist press.

What if your client has yet to make a list of his prized collection, need he put off drawing up his will until he has organized his collection? No, he can use a list as provided for in Va. Code 64.1-45.1. If a will refers to a written statement or list to dispose of items of tangible personal property not otherwise specifically bequeathed, the statement or list shall be given effect to the extent that it describes items of tangible personal property and their intended recipients with reasonable certainty and is signed by the testator although it does not satisfy the requirements for a will. Va. Code § 64.1 - 45.1

Note the two requirements that the list first, be signed, and, second, that it specify the intended recipients. Computer inventory systems do not perform either of these functions so your client must be sure to perform both functions after his computer spits out his list. Although not required, I would strongly suggest that the list be dated. Effective, July 1, 1995, this code section provides that a will may refer to a list written either before or after the execution of this will.

The written statement or list may be referred to as one which is in existence at the time of the testator’s death, may be prepared before or after the execution of the will, may be altered by the testator at any time and may be a writing that has no significance part from its effect on the dispositions made by the will. Va. Code § 64.1 - 45.1

A separate list may not be the best route for each client. A client who does not add and subtract much from his collection and who has only one intended beneficiary for his collection may wish to skip the reference to a list in his will. However, a list would be helpful in either case for purposes of inventorying and estate administration.
However, you should counsel your client that after his will is drafted and after the collection is properly inventoried should he find that his net worth exceeds $625,000 he may wish to consider further estate planning to avail himself of the various provisions of the tax code to reduce any possible estate tax burden.

Planned Giving for the Collector

If your collector client is a member of the NMRA he may wish to gift monies or tangible personal property to this organization as it is a 501(c)(3) organization so such gifts would be tax-deductible while alive. Specifically, gifts of money are deductible up to 50 percent of the donor’s adjusted gross income. IRC §170(b)(1)(A); Reg.§ 1.170A-8. A five-year carryover is allowed for any excess. As is likely with other organizations he may wish to direct which function or entity within the organization should receive his largess. Just for example within NMRA one could designate as beneficiary the Kalmbach Library and specify its Captain Robert Rowe Endowment - proceeds used to purchase books or magazines not available by donation; Charles Eckstein Narrow Gauge Endowment; Valley Forge/Colborn Memorial Publications Fund; or the Finch Operating Endowment. Other funds within the NMRA include: Howell Day Model Railroad Museum Fund; Memorial Fund - contributions in memory of our friends and fellow modelers -General Operations; Team 500 - formerly known as the building fund; Computer Acquisition Fund; and Pacesetters. While your client is unlikely to be a model railroader, the above list should illustrate the wide variety of choices available to one who seeks to benefit his organization(s). The NMR can create an annuity with five thousand dollars and up.

Donating to Others

Just as anyone else, your client may annually give free of federal gift tax $10,000 in monies or tangible personal property (read here “collectibles”) to any individual. So if he and his spouse have, say, five grandchildren he can give $100,000/year for 10 years and transfer a collection worth up to $1 million with no federal tax and skip a generation to boot. This only is important if his estate would otherwise be subject to federal estate taxation.

Of course, donations in kind to other 501(c)(3) organizations can qualify for favorable tax treatment in the form of income tax deductions. Bear in mind that gifts of tangible personal property held either long or short term are deductible at full present fair market value with no capital gain on appreciation if the use of the property is related to the donee’s exempt function. Deductibility is, however, limited to thirty percent of your client’s adjusted gross income. If the gift is unrelated to the donee’s exempt function, the deductibility of your client’s gift must be reduced by the amount of gain that your client would have realized as long term capital gain had the property been sold for its fair market value. IRC § 170(e)-(1)(B).

If your client plans on making a donation in kind (model trains, books, railroadiana) contact the institution(s) first to see if they are interested in accepting his gift. Also be sure that your client has accurately described the planned institutional beneficiary of his largess. Does he have the form of the entity correct? Does he have the correct address of the institution? An institution might turn out too late to be either uninterested in your client’s collection or be otherwise unable to accept it due to space requirements or other reasons. Your client should educate himself about what sort of institutions might accept his collection. In the case of railroad-related collections, likely candidates would be local children’s museums, transportation museums, and local history museums. Of course, each hobby would have its own particular museums with an interest in the subject matter of your client’s collection.

You should assist your client with drafting an agreement delineating the conditions under which his collection will be accepted. Who pays for transportation and insurance? When and how will the collection be exhibited? How will the donor be memorialized by the donee institution? Does the institution intend to sell off all or part of the collection? These questions should be answered by the agreement signed by both donor and donee.

Assistance from Collector’s Organization to help dispose of smaller collections

You should make yourself aware of exactly — and I cannot stress too much this point — what sort of collection we have in mind here. Just as an example, model trains fall into two very different categories. There are collectible toy trains — which are routinely sold at auction houses, both famous and not-so-famous — and then there are scale model trains which are only rarely handled in this previously
mentioned fashion. The executor and you should know the difference. If you do not know the difference, the executor and you should take time to familiarize yourselves with these distinctions. Scale model trains often run on some type of layout. Selling the layout itself is an unlikely eventuality. In fact, there may be some expense involved in disassembling or demolishing the layout. Care should be taken to salvage anything that is salvageable. Although it is beyond the scope of this article, be aware that the value of toy trains, as with other collectibles, is very much influenced by their condition. In fact, original boxes can add significantly to the value of a collection or an individual piece. Be sure that post-death you take steps to insure the physical security of the collection. Also be sure that the collection remains in a dry temperature controlled environment.

Advise your client to prepare a letter telling his loved ones about the location of his will, the name of his attorney, and how to contact the National Model Railroad Association. While other collectors' groups may not be as sophisticated, in the case of the NMRA, an estate counseling committee exists. The NMRA has even gone so far as to produce a videotape — available for a five-dollar rental from its Kalmbach Memorial Library — discussing wills and estate planning in a general way.

Administration

When administering an estate in which a will refers to a list bear in mind,

When distribution is made pursuant to such a written statement or list, a copy thereof shall be furnished to the commissioner of accounts along with the legatee's receipt. Va. Code § 64.1 - 45.1

Also keep in mind that,

A personal representative shall not be liable for any distribution of tangible personal property to the apparent legatee under the testator's will made without actual knowledge of the existence of a written statement or list, nor shall he have any duty to recover property so distributed. However, a person named to receive certain tangible personal property in a written statement or list which is effective under this section, may re-

cover that property, or its value if the property cannot be recovered, from an apparent legatee to whom it has been distributed in an action brought for that purpose within one year after the probate of the testator's will. Va. Code § 64.1 - 45.1

You should place a market value on each asset included in the collection. Remember that the market value of your client's collection is determined as of the date of death. Here is where the NMRA can be useful. They can identify knowledgeable individuals to place a value on these items. The Estate Counseling Committee Job Description cautions "The Chairman shall direct the appraisers that they are not to offer to nor dispose of the estate they have appraised." A good source of information about individuals and firms selling or auctioning toy trains is Classic Toy Trains published ten times a year by Kalmbach Publishing in Milwaukee, Wisconsin and available at news stands. Kalmbach also publishes Model Railroader which covers scale model trains. Do not overlook the photographs and other printed materials the collector may have amassed — these have a value of their own and can often find a ready market. The National Model Railroad Association and its full-time professional staff can be reached at their headquarters at 4121 Cromwell Road, Chattanooga, Tennessee 37421 or 423 892-2846. Just as there are countless valuable web sites discussing model railroads and their real-life prototypes, their counterparts for other collecting interests must surely abound.

Although many practitioners will never have a model railroader walk into their offices seeking estate planning services, is quite likely that you will encounter in someone seeking to probate a will that seeks to dispose of a collection. The example of the model railroader provided in these pages should alert practitioners that there may be more than meets the eye with any collection.

All references herein to the male gender should be considered to include the female gender as well.

Nicholas Kalis is a member the Fairfax and McLean Bar Associations. Nicholas is also a member of the Planned Giving Study Group of Washington, DC. Additionally, the Virginia State Bar Trusts and Estates Section counts Nicholas as a member. Kalis is a member of the Potomac Division of the National
Model Railroad Association. He has been professionally published in publications ranging from Rail Model Journal to Model Railroading.

ENDNOTES


3 It is beyond the scope of this article to discuss scale, gauge, or the vagaries of brass locomotives. A word to the wise, many expensive brass locomotives have been painted and so their value may not be apparent to the uninitiated.
RECENT IRS REGULATIONS PROVIDE PLANNING OPPORTUNITIES FOR EXISTING CHARITABLE REMAINDER UNITRUSTS

By

David L. Lundy

The IRS recently announced that it will extend the deadline for reformation of existing charitable remainder unitrusts (CRUTs) to take advantage of new regulations that permit an income CRUT to convert to the fixed percentage method for calculating payments to the non-charitable beneficiary. Clients who are receiving beneficiary payments based on the net income earned by a CRUT should be informed of this one-time opportunity to change the payment method to a fixed percentage of the annual value of trust assets.

Under final regulations effective December 10, 1998, a net income method CRUT may now provide that it will convert to the fixed percentage method as of a specified date or event. The new regulations permit reformation of existing CRUTs to provide for a conversion from the net income method to the fixed percentage method of calculating beneficiary payments. The regulations require that proceedings to reform the trust be commenced by June 8, 1999. However, the IRS announced on May 21, 1999, that it will amend the regulations to permit reformation if an action is brought by June 30, 2000.

I.

As defined in IRC § 664(d)(2)(A), a CRUT is a trust that provides for the distribution of a fixed percentage of the net fair market value of its assets, valued annually (the “fixed percentage method”). The fixed percentage must be at least 5 percent and not more than 50 percent of the value of trust assets. Distributions must be paid at least once a year to one or more persons (at least one of which is not a charitable organization) for a term of not more than 20 years, or for the lives of individual beneficiaries. Following termination of the payments, the remainder interest in the trust must be transferred to, or for the use of, a charitable organization, or retained by the trust for such use. As of the date that property is contributed to the trust, the value of the charitable remainder interest in such property must be at least 10 percent of the property’s net fair market value.

Section 664 contains an exception to the requirement that trust beneficiaries be paid a fixed percentage of the net fair market value of trust assets. The beneficiaries may be paid the amount of trust income for any year, if such amount is less than the fixed percentage designated for the trust (the “net income method”). The trust instrument also may provide for payment of trust income in excess of the fixed percentage, to the extent that the aggregate of amounts paid in prior years was less than amounts that would have been paid using the fixed percentage method (the “net income with make-up method”).

II.

Before proposing the new regulations, the IRS took the position that the initial method selected for the calculation of beneficiary payments could not be changed during the term of the trust. This limited the flexibility needed by clients who contributed assets that were not readily marketable and produced little income. If a grantor contributed undeveloped real estate to a CRUT, for example, it would not be possible to make payments under the fixed percentage method until the real estate was sold. One of the net income methods could be selected for the trust so that distributions of any income could be made annually as required by the regulations. Once the property was sold, however, the grantor may have preferred receiving a fixed percentage of the reinvested trust assets each year without regard to the amount of income being generated.

In PLR 9506015, real estate was used to fund a CRUT that provided for beneficiary payments of the lesser of annual net income or 8 percent of the net fair market value of trust assets, valued annually. The trust agreement also contained a make-up provision. The grantors intended to provide in the instrument that the net income with make-up method would be replaced by the fixed percentage method following sale of the real estate. They requested a private letter ruling while their petition for court reformation was pending. The IRS stated that a change in payment methods would disqualify the trust, causing it to lose its tax-exempt status.

As a result of changes made by the Tax Reform Act of 1969, a remainder interest in property transferred in
trust to a charitable organization qualifies for the charitable deduction for federal income, gift, and estate tax purposes only if the trust is a charitable remainder annuity trust described in section 664(d)(1) of the Code, a charitable remainder unitrust described in section 664(d)(2) or a pooled income fund described in section 642(c)(5). The purpose of these changes was to remove any incentive to manipulate trust investments for the benefit of noncharitable income beneficiaries to the detriment of the charitable remainder beneficiaries.

Pursuant to section 664(d) of the Code, the amount payable to non-charitable beneficiaries from a qualified charitable remainder unitrust must be computed using one of three methods as selected by the terms of the trust's governing instrument. Those methods are the fixed percentage method, the income exception method, or the income exception with make-up method. To prevent possible manipulation of trust assets to the detriment of the charitable remainder interest, the trust's governing instrument must select one of those methods and that selected method must be used during the entire term of the trust. The governing instrument may not provide for a change in the method of computing the unitrust amount during the term of the trust. In addition, the governing instrument may not be reformed to provide for a change in the method of computing the unitrust amount without adversely affecting the qualification of the trust under section 664.5

III.

A trust that makes beneficiary payments using one of the net income methods, and subsequently converts to the fixed percentage method of payment, generally is referred to as a "flip-CRUT." The IRS changed its position against flip provisions when it published proposed regulations in 1997.

The final regulations, which are effective December 10, 1998, permit the creation of flip-CRUTs in which the change from the net income method to the fixed percentage method "is triggered on a specific date or by a single event whose occurrence is not discretionary with, or within the control of, the trustees or any other persons."6 Such events are defined to include the sale of unmarketable assets, or marriage, divorce, death, or the birth of a child with respect to any individual.7 "Unmarketable assets" are assets that are not "cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents."8 Examples include real property, closely held stock, and an unregistered security for which there is no available exemption permitting public sale.

The change in payment method must occur at the beginning of the taxable year following the year in which the specific date or triggering event occurs.9 Following the change, any "make-up" amount that has not been paid is forfeited.10 When the trust converts to the fixed percentage method, it must use the same percentage that was designated for the trust as the maximum amount payable under the net income method.11

IV.

Net income method CRUTs, including those with make-up provisions, may be reformed under the new regulations to permit conversion to the fixed percentage method.12 Such reformations also are permitted for trusts with existing flip provisions that do not comply with the final regulations. The event that triggers conversion under the reformed instrument may not occur in a year prior to the year in which the court orders reformation, unless the governing instrument of a trust prior to reformation already provided for beneficiary payments under an impermissible combination of methods, and the triggering event occurred prior to reformation.

The regulations require that the trustee begin legal proceedings to reform the trust by June 8, 1999. In its recent notice, however, the IRS announced that it will amend the regulations to extend the deadline to June 30, 2000.13 The amendment will be effective December 10, 1998.

The IRS notice states that the term "legal proceedings" includes non-judicial reformations that are valid under state law, but such reformations must be completed by June 30, 2000.
The Virginia Code provides for non-judicial reformation of charitable remainder trusts to conform such trusts to requirements for exemption from federal taxes. Section 55-29.1 provides that the trustee or trustees of such trust, with the concurrence of the creator of the trust (if then living and able to give such consent) and the Attorney General, may, without resort to any court, unless such amendment is inconsistent with an express provision of such trust’s governing instrument, amend the terms of such trust to bring such trust into or continue such trust in conformity with requirements for exemption of such trust, or any interest therein, from federal taxes.

If an existing flip provision does not comply with Treasury regulations, the Virginia statute might be interpreted to permit amendment of the trust instrument without court intervention because such amendment would bring the trust into conformity with the requirements for tax exemption. The statute also requires, however, that any amendment not be inconsistent with an express provision of the trust. An amendment that permits a proper flip provision could be deemed inconsistent with the existing terms of a trust, depending on the nature of the improper provision.

A net income method CRUT that complies with all requirements for tax exemption also may seek reformation to add a flip provision to its governing instrument. Section 55-29.1 permits non-judicial reformation “to bring such trust into or continue such trust in conformity with” the requirements for tax exemption. In this case, the purpose of the reformation is to provide the income beneficiary with a desired payment option; reformation is not being undertaken to maintain the exempt status of the trust. Another problem with non-judicial reformation in this context is that a flip-provision amendment could be deemed inconsistent – under § 55-29.1 – with the net income method contained in the trust’s governing instrument.

Practitioners who are concerned about the effectiveness of a non-judicial reformation should consider bringing an action under Va. Code § 55-19.4. The statute authorizes a Virginia circuit court to modify a trust in any manner, on a showing of good cause. The court must find, however, that such action will not adversely affect the interests of any beneficiary. “Good cause” may be shown by evidence of changes in federal tax laws which, if modification were made, would materially benefit the trust or the interests of the trustor or any beneficiary.

If a net income method CRUT is reformed to allow conversion to the fixed percentage method, the non-charitable income beneficiary may benefit financially to the extent that trust income falls short of the fixed percentage designated for the trust. In such case, there may be a corresponding financial detriment to the charitable remainderman. In an action to reform, good cause may be shown if there will be a “material benefit” to the income beneficiary. The court may question whether such benefit, once established, will prevent a finding under § 55-19.4(B) of no adverse effect on the charitable interest.

The new regulations provide flexibility for clients who want to establish a net income method CRUT funded with unmarketable assets, and retain the ability to receive payments based on the fixed percentage method once those assets have been sold. The regulations also provide a one-time opportunity for beneficiaries of existing CRUTs to add a flip provision to the governing instrument of the trust.

If reformation of an existing trust is desired, practitioners should consider whether a court-ordered modification would be appropriate. The limited application of § 55-29.1 suggests that judicial involvement may be necessary in most cases. In an action to reform under § 55-19.4, a material benefit must be shown, together with the absence of any detriment that could be caused by the proposed reformation. The action should include the Attorney General on behalf of the charitable interest.

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ENDNOTES

1 IRC § 664(d)(2)(C).
2 IRC § 664(d)(2)(D).
3 IRC § 664(d)(3)(A).
5 PLR 9506015 (citations omitted). See also PLR 9516040 (same conclusion based on Treas. Reg. § 1.664-3(a)(4), which provides that the trust may not be subject to a power to invade, alter, amend, or revoke for the benefit of a non-charitable beneficiary); and PLR 9522021 (reformation permitting change in payment method would be self-dealing under IRC § 4941 because it could transfer assets from the charitable remainderman to the income beneficiary).
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