Message From The Chair

With 1,227 members (as of 8/98), the Trusts and Estates Section is the 5th largest Section of the Virginia State Bar. Our goal is to promote the exchange of ideas among attorneys dealing with wills, estates, trusts and related matters. In addition to monitoring legislation introduced into the General Assembly and sponsoring CLE seminars on topics of concern and general interest to the membership, the Section publishes this Newsletter designed to advise our membership on current developments on estate planning and administration.

We welcome articles and suggestions for topics from our members. As one of our two publications next year, plans are already underway to produce a dedicated issue of the Virginia Lawyer focusing on trusts and estates. The issue will be published in December 1999 with an estimated circulation of 20,000, sooooooo if you have been holding back, this is your chance to call our current editor, Bill Gust, at (540) 983-9300 to "get yourself in print."

For those of you who have recently joined us, the VSB Trusts and Estates Section was officially established on January 1, 1979, upon the division of the former Estates and Property Section of the Bar. Our first issue of the Newsletter (Vol. I/No. 1) was published in the Summer of 1980 with a briefing on the 1980 Session of the Virginia General Assembly by then Legislative Advisor for the Section, Bill Gray. It has since been our objective to provide a viable means of communication among practitioners in the trusts and estates field around the state.

If you would like to become more involved with the Trusts and Estates Section, or have ideas you would like to share, please feel free to contact me or any of the current members of the Board of Governors (listed on the back cover). We would enjoy hearing from you!

With best regards,

Kirkland M. Kelley

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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.
REFORMING VIRGINIA'S POUR-OVER RULES — THREE PROPOSALS

By

J. RODNEY JOHNSON

Introduction. Forty years have passed since Virginia enacted legislation authorizing a testamentary pour-over into an existing inter vivos trust — a development that a contemporary commentator categorized as placing a testator "roughly in the position of a royal subject in Virginia prior to 1748. He has enviable flexibility." Although much of this flexibility still exists today, developments during the intervening forty years have combined to make Virginia's treatment of pour-overs something less than "enviable" when compared to almost every other state. This short article argues for the elimination of Virginia's pour-over problems by the enactment of three-part legislation that would (1) replace Section 64.1-73 with The Uniform Testamentary Additions to Trusts Act (1991); (2) eliminate the requirement that a non-resident serving as sole trustee of a receptacle trust post bond with surety; and (3) abolish the prohibition against out-of-state banks serving as trustees of receptacle trusts. A draft of the suggested legislation is attached. As this article is addressed to the members of the Virginia State Bar's Section on Trusts and Estates, it is written on the assumption that the reader is well versed in the uses and mechanics of pour-over wills and receptacle trusts. Accordingly, there will be no need to provide a comprehensive analysis of pour-over law in general, or of the Virginia statute in particular, before beginning a discussion of the problems and their solutions.

The Advantages of Uniformity and the Birth of UTATA. To mention the mobility of the American people is to state the obvious. And this would also be true of a reference to the geographic diversification of so many families and their wealth — whether this be accidental or intentional. In the context of planning for these clients with multi-state beneficiaries and/or assets, the task of the estate planner is made significantly easier if the same law governs all aspects of the estate plan — whether that estate planner is a Virginian looking outward or an out-of-state attorney working on a plan with a Virginia aspect. To this end, i.e., to help bring uniformity to state laws governing pour-over wills and receptacle trusts, the National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated the Uniform Testamentary Additions to Trusts Act in 1960. Three decades later NCCUSL revised the 1960 Act (i) to clarify certain aspects of the original, and (ii) to increase its intent-effectuating characteristics. The revision was promulgated as the Uniform Testamentary Additions to Trusts Act (1991), hereafter referred to as UTATA. At the present time, 45 states and the District of Columbia have adopted one of these two Acts. In addition to Virginia, the other non-enacting states are Louisiana, Missouri, Nebraska, and Wisconsin.

Comparing UTATA to Section 64.1-73 — Form. It may come as a surprise that there are only three differences between the substance of present Virginia law and UTATA. This might be due to the form of Section 64.1-73 which, as a consequence of having been amended ten times since its enactment, has evolved (degenerated?) into a rather awkward, two-page statute of 1,234 words. UTATA, on the other hand, resolves the same issues more efficiently in only 487 words (including its Virginia modifications).

An out-of-state attorney from any of the 46 Uniform Act jurisdictions who is considering an estate plan involving a bequest or devise to a receptacle trust in Virginia is likely to assume, upon seeing our statute's length and complexity, that it must be significantly different from whichever Uniform Act happens to be in force in his state. Otherwise, why the length? Moreover, the fact that Virginia has not enacted either version of the Uniform Act would appear to provide corroboration for this conclusion. Of course a study of our two-page statute would show this out-of-state attorney that his initial assumption is in fact erroneous. However, the nature of the practice will not always justify the billable time that would be required to make this analysis in the typical case. Instead, the out-of-state attorney will often suggest some other alternative to the client, who might end up with a "second best" estate plan. A comparable problem is presented to the Virginia attorney who does not specialize in estate
planning but who, from time to time, is presented with a situation where a pour-over might seem to be the preferred approach to reach a given objective. And so, the Virginia attorney goes to the code to "check it out" and there finds the two-page statute in question. However, as estate planning is only an incidental part of this attorney's practice, he, like the out-of-state attorney will not be able to understand the intricacies of Section 64.1-73 without a certain amount of study. And again, the economics of law practice are often going to preclude the costs of that study being charged to the present client or being absorbed by the attorney. The net result is the likely possibility of another "second best" estate plan for the client.

One immediate benefit of adopting UTATA's shorter and simpler language would be the elimination of the negative presentation that Section 64.1-73 made to both of these attorneys. In addition, it should be noted that there really are no authoritative resources to which an attorney might turn for an exposition of Virginia's pour-over statute if, for whatever reason, time and billing considerations are not a precluding factor. On the other hand, NCCUSL always provides official commentaries to assist the reader in understanding and applying its uniform acts. Moreover, because of the national importance attached to acts that receive wide-spread adoption, they are always the subject of expository and planning commentary in the national estate planning literature. Accordingly, a strong case can be made for Virginia's adoption of UTATA for at least three non-substantive reasons — uniformity, relative simplicity and the ready availability of authoritative educational and planning resources.

Comparing UTATA to Section 64.1-73 — Substance. As noted previously, Virginia's pour-over statute provides for the same results found in UTATA except in three instances. It simply takes Section 64.1-73 almost three times the length of UTATA to state these results. The three instances where the results under UTATA differ from those under present Virginia law, which are all categorized by NCCUSL as being "intent-effectuating improvements," are described in the following three paragraphs.

First, Virginia law presently provides that, for a valid pour-over to an inter vivos trust, the inter vivos trust document must have been executed "before, concurrently with, or after" (emphasis added) the testator's pour-over will. Although sequence of execution is not a major matter in the typical case, it can be the controlling factor in a given case, determining whether or not the testator's estate plan will succeed or fail. It is submitted, however, that the decision of success or failure should never be based on any such trivial concern. Nevertheless, anecdotal evidence indicates that there continue to be instances in which, due to inadvertence or design, the receptacle trust document is not executed "before or contemporaneously with" the will and in which, then, the intended pour-over must clearly fail under present law. UTATA's intent-effectuating rule, which would save the testator's estate plan in these cases, is clearly the better one and thus should be adopted in Virginia.

Second, Virginia law presently provides that a pour-over "shall not be valid should the entire trust not be operative for any reason at the testator's death." UTATA, on the other hand, provides that "(u)less the testator's will provides otherwise (emphasis added), a revocation or termination of the trust before the testator's death causes the devise or bequest to lapse." Thus, instead of governing this situation with an absolute rule of law mandating failure, as Virginia presently does, UTATA provides for a default rule of invalidity that can be changed by the testator. It can be conceded, arguendo, that the testator may typically desire the pour-over to lapse if the receptacle trust does not exist to receive it. But to say "typically" is to recognize that there will be a certain number of instances where such a failure would definitely frustrate a testator's legitimate intent. Yet every such pour-over is condemned by Virginia's absolute rule. Suppose a testator, in a given case (probably one making a pour-over into a trust created by another), expressly provides that the intended pour-over shall be effective notwithstanding the non-existence of the receptacle trust at testator's death. It is submitted that no practical or policy reason can be offered for not honoring the testator's intent in such a case, and thus Virginia's present absolute prohibition ought to be eliminated.

UTATA's intent-effectuating rule is the better one and should be adopted in Virginia.

Third, in regard to post-death amendments, Virginia law presently provides for a pour-over to be governed (i) in accordance with the receptacle trust's terms as of the testator's death, or (ii) "if the testator expressly so specifies in his will, and only in such event, as such terms are amended after the death of
the testator." Under UTATA, on the other hand, a pour-over is governed in accordance with post-death amendments to the receptacle trust's terms "unless the testator's will provides otherwise." Thus, under both rules, the testator's intent regarding post-death amendments will control — if that intent is stated in his will. However, if the will is silent on the issue of intent, Virginia's default rule rejects post-death amendments while UTATA's default rule honors them. The question thus arises: Which default rule is most likely to be consistent with the testator's intent, and in the best interests of his estate plan, in those cases where his will provides no guidance? A major factor leading the writer to answer "UTATA" is the recognition that more and more estate planners are drafting trusts that last for longer and longer periods of time. In addition to this development being driven by the age-old desire for control, we now see (i) the restraining aspect of the common law Rule Against Perpetuities being reduced in some states and completely abandoned in others, and (ii) increasing client wealth leading to a corresponding increase in sheltering the generation-skipping transfer tax exemption for as long as possible.

One thing is certain to occur as we deal with these longer duration trusts — change. There will be changes in tax law, environmental law, the stock market, the needs of beneficiaries, etc., that will have a continuing impact on the trust's operation within the framework of the testator's intent. For this reason, an increasing number of estate planners now include a mechanism in some inter vivos trusts to provide for their continuing amendability after the settlor's death. In these cases, as well as those in which the need was not foreseen by the drafter but a post-death modification of the receptacle trust has been accomplished by other means, it is submitted that the typical testator would want the pour-over amount to be governed by the same modification. And such is the default rule of UTATA. Thus, for the third time, UTATA's intent-effectuating rule is the better one and should be adopted in Virginia.

Out-of-State Bank as Trustee of Receptacle Trust. Although Virginia law concerning a non-resident individual serving as a sole trustee of a receptacle trust has evolved from a pre-1991 absolute prohibition to a 1996 open-door policy,¹¹ the absolute prohibition against an out-of-state bank serving in such a capacity continues in full force. Why this disparity? It certainly cannot be said to be for the protection of the beneficiaries, or to increase the likelihood that the decedent's intent might be more accurately honored because, on balance, the out-of-state professional fiduciary is more likely to do the right thing more often than would the out-of-state layman. The only apparent reason for the prohibition against the out-of-state banks has been the desire to protect Virginia banks from any outside competition. Assuming that this was defensible public policy at one time, this basis has been substantially eliminated in light of the recent subordinate coupling of most major Virginia banks with foreign ones.

Moreover, the prohibition against an out-of-state bank serving as the trustee of a receptacle trust can be easily circumvented if such be the desire of the parties. The writer has been advised of the practice followed by one out-of-state bank, in some cases, of having the trust documents name one of the bank's trust officers (resident in northern Virginia) as the trustee, who will then qualify and serve as the institution's puppet. A far simpler approach, and the one that makes all foreign banks eligible, is to name a Virginia resident as trustee of the receptacle trust who, following the receipt of the pour-over and the estate's final accounting, will simply resign and appoint the originally intended out-of-state bank as successor trustee (pursuant to a very standard and innocently appearing clause in the trust). There are a reasonable number of cases where all of a Virginian's beneficiaries live out of state, and it will often make sense for such beneficiaries' trusts to be administered in their locality. It is submitted that, in these cases, no legitimate argument can be made to support a rule that allows a non-resident individual to serve as trustee of the receptacle trust and yet denies Virginians the privilege of using an out-of-state bank.

Eliminating the Surety Requirement. When Virginia's absolute prohibition against any non-resident individual serving as a sole personal representative was first relaxed in 1983, two requirements were imposed upon the limited group of the individuals who were granted permission to serve. First, the non-resident individual must appoint a resident agent for receipt of process in estate-related matters. Second, the non-resident must post bond with surety, notwithstanding any language in the will purporting to waive the surety requirement.¹² When the prohibition against making a pour-over to a receptacle trust that had a non-resident serving as sole trustee was first relaxed in 1991, these same two requirements were also imposed upon the non-resident individuals who were authorized to serve.
Although this parallel treatment undoubtedly seemed logical at the time, there was a significant flaw in this logic regarding the imposition of the mandatory surety requirement, and this surety issue has also raised some unanswerable questions in the offices of both the Clerk of Court and the Commissioner of Accounts.

A non-exclusive listing of these problems might begin from the standpoint of the clerk, who must set the amount of the trustee's bond and take the surety. On what amount is the bond to be based? On the value of the entire trust or only the value of the pour-over? It appears that the clerk must require the submission of at least a certified copy of the inter vivos trust in order to verify the required identification of trust, trustee, power to sell real estate, etc. What, then, does the clerk do with this copy of the inter vivos trust? Clearly the clerk must preserve it as a record to support his or her actions, but does the clerk record it and thereby destroy the privacy that was one of the reasons for using the inter vivos trust in the first place? If not, what does the clerk do? And, in either case, what is the authority for the clerk's action? After the initial bond and surety is set in the clerk's office, how is its continuing adequacy monitored? The Commissioner of Accounts is charged with this task in connection with all fiduciaries who are required to file annual accountings. But there is no requirement that the trustee of a receptacle trust make any accounting to the commissioner. Or, is there now an implied requirement for this trustee to make some kind of "submission" to the Commissioner of Accounts in order that the commissioner might ensure the continuing adequacy of the trustee's bond and surety? And, if the commissioner is supposed to verify adequacy of bond and surety, does the commissioner file a copy of the "submission" and a report of his actions with the court in the same way he does with an accounting? If so, won't this be automatically recorded by the clerk, thereby again breaching the intended privacy? Although these concerns vary in terms of importance, they add up to a very significant problem that appears to have only three possible solutions: (1) legislation directly addressing each issue; (2) retreating to the pre-1991 rule prohibiting pour-overs where the sole trustee is a non-resident; or (3) eliminating the bond and surety requirement for non-resident trustees of receptacle trusts. In addition to the obvious negatives associated with possible solutions (1) and (2), a further reality that must be recognized in connection with both is the simple negation mechanism previously discussed in connection with out-of-state banks. Thus, it is submitted that solution (3) — elimination of the bond and surety requirement — is the correct choice, and this is particularly so in light of the discussion in the following paragraph.

In examining the original reason for imposing a mandatory surety requirement on non-resident personal representatives in 1983, and on testamentary trustees in 1986, one discovers that this imposition was designed to help the Commissioner of Accounts force recalcitrant fiduciaries to comply with their inventory and accounting requirements. Although the commissioner has statutory remedies that are readily enforceable against Virginia fiduciaries, his office has no effective authority over a non-resident who takes the assets out of state and remains there. Thus, the requirement of the bond secured with non-waivable surety was created as a device to insure that a non-resident serving as a sole personal representative or serving as a sole testamentary trustee would comply with the inventory and accounting requirements. This makes sense. But there are no such inventory and accounting requirements imposed on the trustee of an inter vivos trust. Thus, the extension of the compliance device (bond and surety) to a situation where there is nothing with which to comply, does not make any sense and ought to be abolished.

Conclusion. The forty years that have passed since Virginia enacted its initial pour-over legislation have witnessed an important estate planning tool become less "user-friendly" to attorneys and less responsive to the needs of their clients. The replacement of our present statute with UTATA would give us (i) relative simplicity in all cases, (ii) uniformity in multi-state cases, (iii) ready availability of authoritative educational and planning resources, and (iv) an increase in our intent-effectuating estate planning rules. Attached to this article is a draft for legislation that, for these reasons, would adopt UTATA, and would also, for the reasons discussed in the text, (1) eliminate the flawed requirement that a non-resident serving as sole trustee of a receptacle trust post bond with surety, and (2) abolish the superficial prohibition against out-of-state banks serving as trustees of receptacle trusts. On October 17, 1998, the Virginia Bar Association's Executive Committee, acting at the request of the VBA's Section on Wills, Trusts, and Estates, voted to make this proposal a part of the Association's legislative
PROPOSED POUR-OVER LEGISLATION

§ 64.1-73.1. Uniform Testamentary Additions to Trusts Act (1991). — A. A will may validly devise or bequeath property (including by the exercise of a power of appointment) to the trustee of a trust established or to be established (i) during the testator's lifetime by the testator, by the testator and some other person, or by some other person including a funded or unfunded life insurance trust, although the settlor has reserved any or all rights of ownership of the insurance contracts, or (ii) at the testator's death by the testator's devise or bequest to the trustee, if the trust is identified in the testator's will and its terms are set forth in a written instrument, other than a will, executed before, concurrently with, or after the execution of the testator's will or in another individual's will if that other individual has predeceased the testator, regardless of the existence, size, or character of the corpus of the trust. The devise or bequest is not invalid because the trust is amendable or revocable, or because the trust was amended after the execution of the will or the testator's death.

B. Unless the testator's will provides otherwise, property devised or bequeathed to a trust described in subsection A is not held under a testamentary trust of the testator but it becomes a part of the trust to which it is devised or bequeathed, and must be administered and disposed of in accordance with the provisions of the governing instrument setting forth the terms of the trust, including any amendments thereto made before or after the testator's death.

C. Unless the testator's will provides otherwise, a revocation or termination of the trust before the testator's death causes the devise or bequest to lapse.

D. Unless at least one trustee of the trust is an individual resident of this Commonwealth or an entity authorized to do a trust business in this Commonwealth, at the time the devise or bequest is to be distributed to the trust, the testator's personal representative shall not make any distribution to the trust until each non-resident individual and/or entity files with the Clerk of the Circuit Court of the jurisdiction wherein the testator's will was admitted to probate, a consent in writing that service of process in any action against the trustee or any other notice with respect to administration of the trust in the trustee's charge, may be by service upon a resident of this Commonwealth at such address as the trustee may appoint in the written instrument filed with the clerk. No further requirement shall be imposed upon any non-resident individual or entity as a condition to receiving the devise or bequest.

E. This section applies to a will of a testator who dies after June 30, 1999, and it shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this section among states enacting it.

ENDNOTES
1. Professor of Law, University of Richmond, Virginia. This article was drafted while the writer was serving as chair of a committee studying the Uniform Testamentary Additions to Trusts Act (1991) for the Virginia Bar Association's Section on Wills Trusts and Estates. The other members of this committee were C. Daniel Stevens, of Christian & Barton, L.L.P., and Harry J. Warthen, III, of Hunton & Williams. The writer is indebted to these colleagues for their thoughtful comments and suggestions during the committee's study; however, the opinions expressed in this article, and any errors found herein, are the sole responsibility of the writer.


3. This ease of task will also often result in better drafting and lower overall transaction costs, as well as increasing the number of options available to the client.

4. The writer serves as a Virginia Commissioner to the National Conference of Commissioners on Uniform State Laws.

5. UTATA is also found as Section 2-511 of the Uniform Probate Code (1990), and as Section 2-511 of the Uniform Act on Intestacy, Wills, and Donative Transfers.

6. It's crowning masterpiece is one sentence that contains 201 words.
7. For an early discussion of the sequencing issue, in the context of a pour-over to an insurance trust, see Ellsworth Wiltshire, *Pour-Over Devise or Bequest to Life Insurance Trust — Sequence of Execution of Papers*, 1 University of Richmond Law Notes 221 (1961).

8. In such a case, under UTATA, the attempted pour-over would be held in a trust governed by the terms of the receptacle trust (now revoked as to its original corpus), on principles paralleling the familiar concept of incorporation by reference.

9. House Bill No. 645, designed to eliminate the Rule Against Perpetuities in some cases, was introduced into the 1998 Session of the Virginia General Assembly, and carried over to the 1999 Session.


13. The answer to this question is not as obvious as it might seem, because § 64.1-73(A)(2) provides in part that "(w)here any nonresident qualifies (emphasis added) pursuant to this paragraph, bond with surety shall be required . . ." The argument is made that if the trustee of the receptacle trust must qualify before the clerk then, as in all other cases where a fiduciary qualifies before the clerk, the clerk must set bond based upon the entire amount under the fiduciary's control.

14. If, for instance, Virginia goes back to the pre-1991 prohibition rule, its requirements can be easily avoided by having a resident as the initial inter-vivos trustee who will, after the pour-over distribution has been received and the decedent's estate has been closed, resign in favor of the intended non-resident.

15. The other requirement presently imposed on the non-resident serving as sole trustee of a receptacle trust is appointing an agent to receive service of process in trust-related litigation brought in Virginia. This is a good provision, for obvious reasons, and thus it is preserved in the attached legislative proposal.

16. The entire proposal is drafted to be effective on a prospective basis, with present Section 64.1-73 being retained to govern pre-enactment pour-overs.
Gift-giving of undivided interests in land is an uncomplicated way of obtaining valuation discounts. Favorable developments in case law make these transfers increasingly attractive, and planning opportunities abound in a variety of fact patterns including uses with other techniques. This article explores the tax-saving advantages, the current status of the law, some factors relating to discounts and some planning possibilities in connection with this kind of planning which promises to become a basic tool of every planner.

I. Advantages

Discounted gifts leverage donor's annual exclusion by removing from donor's estate value in excess of the exclusion amount. For instance, assuming a 20% discount, $12,500 in value can be sheltered by a $10,000 exclusion. Similarly, where an asset in a decedent's estate is entitled to a valuation discount, the value otherwise exposed to estate taxes will be reduced: A $1,250,000 asset would have a value of $1,000,000 after a 20% discount.

Gifts of undivided interests in real property produce a double advantage - both the value of the fractional interest given away and that of the fractional interest retained are discounted. Thus, assuming a 20% discount, gifts by donor to each of donor's four children of a .9615% interest in a parcel of real property valued at $1,300,000 will have a value for transfer tax purposes of approximately $10,000 each, even though approximately $12,500 in underlying value is being given away to each donee. Upon donor's later death, assuming static underlying values and a 20% discount, donor/decedent's 96.154% interest, worth approximately $1,250,000 of underlying value, would be valued at approximately $1,000,000 for transfer tax purposes. Accordingly, on these facts and assumptions, one set of four annual exclusion gifts will eliminate not just $40,000 but $300,000 of value from donor/decedent's estate.

This planning technique can be implemented by a simple deed and the resulting co-ownership form does not normally require extra tax returns or specialized legal or accounting assistance.

II. State of the Law

Valuation discounts for transfers of undivided interests in real property have been the subject of case law for over 80 years. Throughout this period, not unpredictably, the Internal Revenue Service, on a variety of grounds, has resisted such discounts. Most recently the position has been that any discount should be limited to the cost of a partition action. This position has been thoroughly rejected by every court that has dealt with the subject. For instance, in Estate of Barge, a gift tax case in which the only issue was the proper discount of a gift of a 25 percent undivided interest in timberland, the Tax Court refused to rely on the cost of partition of the property, but based its opinion on the present value of the expected cash flows from the future harvesting of timber until partition would be likely to occur, arriving at a value equivalent to a 26 percent discount.

In the most recent case of Estate of Williams v. Commissioner, the Tax Court likewise rejected the cost-of-partition limitation and discounted the value of gifts of one-half interests in two parcels of timberland by 20 percent for lack of marketability and an additional 30 percent for lack of control, applying the discounts seriatim for an effective 44 percent discount. The large size of the discount reflects the fact that the government submitted no appraisal testimony on the magnitude of the discount, but, instead, conceding a mere five percent discount, contended that taxpayer failed to meet the burden of proof because taxpayer had offered no evidence of actual sales of fractional interests. In rejecting this contention, the court emphasized that a banker credibly testified that banks generally will not lend money to the owner of a fractional interest in real property without the consent of the co-owners and that the inability of the appraisers to find sales of fractional interests in comparable real property showed that there was no market for fractional interests in such real property. The court further noted favorably the testimony by taxpayer's appraiser that the holder of a
fractional interest in real property lacks control because such holder cannot manage it unilaterally.9

After Williams, and its immediate antecedents, the issue is not whether a discount will be allowed, but based on the facts of each particular case, what will be the size of an appropriate discount.10

III. Rationales For Discounts

The premise for fractional interest discounts is that each tenant-in-common, regardless of the size of such tenant's interest, is entitled to possess and use the co-owned property and, without resort to partition, cannot "oust" the other co-owners.11 This forced sharing of access (rather than lack of access) has the potential to create significant confusion and upheaval.12 Further, since even a co-tenant with the smallest fractional interest has a right to operate the property subject to the identical right of each of the other co-owners, all co-owners must agree to all decisions related to the property if the operation is to be a success. A co-tenant thus has a veto, and disagreements can lead to gridlock.13 Judgment creditors of any co-tenant may secure a lien on such tenant's undivided interest and compel partition. In addition, the identity of a co-tenant can change with death or divorce. Finally, as noted in the Williams case,14 financial institutions will not provide a loan on undivided interest property where the property is the sole collateral unless all undivided interest holders sign the loan documents.

With the foregoing disadvantages in mind, why would a hypothetical willing buyer15 purchase a fractional interest without a sizable discount?

Each co-tenant, even one with just a minor or "sliver" interest, has the power to compel partition. The right of partition cuts both ways. It is valuable to the co-tenant desiring partition, less so to those in favor of the status quo. In a partition action, the court may partition the real property in kind, under which the property is physically divided in equitable proportions.16 If, however, division in kind is inconvenient, the court may alternatively allot the entire property to a co-tenant who will accept it and pay to the other co-tenants cash for their pro-rata shares. As a final possibility, if division in kind is inconvenient and the interests of all co-tenants will be promoted by a sale of the entire property, the court may order a sale and a pro-rata division of the proceeds.17 Where more than one co-tenant entitled to partition seeks allotment of the entire property to himself, a Virginia trial court does not abuse its discretion in refusing allotment to either of them and ordering the property to be sold.18

Once the partition action begins, absent agreement of all co-tenants, the sales process is out of the hands of each co-tenant, and whether a co-tenant agrees to the bid subsequently confirmed by the court is irrelevant.19 As in any judicial sale, the trial court can accept bids until the final decree is entered.20 In practice once the special commissioner of sale has been authorized by the court to sell the property,21 such commissioner solicits bids over a reasonable period of time and generally accepts the highest non-contingent, reasonable bid subject to confirmation by the court. In such a system, a co-tenant has no veto but is limited to outbidding the highest bidder. To say that such co-tenant is a "willing seller" is problematic. Also, since the period of bidding is limited in practice, taking the property off the market until it improves is usually not an alternative. Because the sales process is placed outside the control of any co-tenant in a partition action, in many cases the mere threat of partition will cause the co-tenants to agree to sell the property.

Not only does the partition process lead to a forced sale, it is also fraught with the possibility of high costs22 and significant delays.23 The prospect of delay depresses the investment desirability due to the uncertainty of what the underlying property will likely be sold for at the end of the partition process. Since the property in partition is tied up over an extended period of time during which market conditions may fluctuate, opportunities for favorable sales may be lost. Several studies, including one involving private placement of Rule 144 stock (forced holding period of two years - 24% discount), a later one involving 160 Rule 144 securities (overall average discount 20%, those companies with less then $10 million in market value having an average discount of 31%), and one involving liquidating secondary market limited partnerships (discount 26%), have in analogous situations attempted to quantify the discount associated with forced time delay similar to that inherent in the partition process.24

In summary a willing buyer will not purchase an undivided co-ownership interest for a price equal to the overall value of the property times the amount of the percentage interest, but will insist upon a discount because forced sharing of control is intrinsic to a tenancy-in-common and there is uncertainty whether a sale in partition, due to its forced nature
and the costs and delays involved, will yield a price truly reflective of fair market value.

IV. Application of Discounts

Although not entirely free from discussion,25 in a gift tax setting under current law, discounts are applied with "blinders" on, that is, you look simply at what is being transferred, not who is doing the transferring or who is getting the transfer26 or the existence of other transfers by or to the same persons or what is being retained.27 Accordingly, where the owner of an undivided 50 percent interest in real property gives the interest to the other 50 percent co-owner, such gift would be viewed in isolation, and its value for gift tax purposes would be entitled to a discount.

On the other hand, an undivided interest transferred at death will be aggregated for estate tax valuation purposes with all other interests owned at death by decedent in the same property.28 Thus, fractionalization of decedent's interest in a parcel occurring post-death will not result in discounts in valuing the parcel on decedent's estate tax return.29 For example, where decedent devises equal percentages of decedent's vacation home to decedent's children, the full fair market value of the home will be includible in decedent's estate.

Similar to the gift tax situation, decedent's property is valued without regard to the identity of the beneficiary. The principle as stated in Propstra v. United States30 is as follows:

Because the estate tax is a tax on the privilege of transferring property upon one's death, the property to be valued for estate purposes is that which the decedent actually transfers at his death rather than the interest held by the decedent before death or that held by the legatee after death.31

In an earlier case, Estate of Lee v. Commissioner,32 cited in Propstra,33 the Tax Court had declined to aggregate, for purposes of determining whether decedent had a controlling interest, decedent's 50 percent undivided interest in common stock with a like interest owned by her husband-beneficiary.34 In Estate of Andrews v. Commissioner,35 the Tax Court refused to attribute decedent's siblings' 80 percent stock interest to decedent, holding that the value of decedent's 20% interest was entitled to a combined 60%

discount for lack of control and lack of marketability.36

In Estate of Pillsbury v. Commissioner,37 the Tax Court, in allowing a 15 percent discount, stated that it would not apply attribution principles to combine a 77 percent undivided interest in real property held in trust for decedent with the other 23 percent interest held by the same trustee for the benefit of issue of decedent's late spouse.38 Finally in the Estate of Bonner v. Commissioner,39 the Fifth Circuit held that the value of undivided fractional interests in real and personal property owned outright by decedent were entitled to a fractional interest valuation discount for estate tax purposes inasmuch as such interests did not have to be aggregated with the remaining interests (in such property) which were held by a QTIP trust established for decedent's benefit by his wife and included in decedent's estate under Sec. 2044 of the Internal Revenue Code.

V. Size of Discounts

Discount percentages in cases allowing fractional interest discounts have ranged from 5 to 60 percent, with quite a few decisions at 10 percent and 15 percent.40 More recently, the spread seems to be between 15 to 20 percent.41 Setting the size of the discount is largely a matter of expert opinion; however, one nationally known planner simply obtains an appraisal of the value of the overall property, multiplies the ownership percentage by such overall value and then discounts by 20 percent (without using an expert for the discount).42

Any appraiser hired to determine an appropriate discount in a given case should be thoroughly familiar with discount strategies related to more sophisticated techniques.43 In particular, the appraiser should be sensitive to the time value of money and have knowledge of relevant studies related to forced holding periods.44 In addition, the appraiser should have facility with various valuation methodologies including the capitalization of cash flow and holding company methods. The appraiser should consult with a lawyer who has expert knowledge concerning tenancies-in-common and the partitioning process in the locality of the property. Besides developing a data base concerning the ease of divisibility of the parcel in question, sales of comparable fractional interests, if any, the availability of financing for the interest and costs, time and forced control issues, the appraiser should note any special difficulties related
VI. Planning Observations

In every potentially taxable estate, the planner should consider advising the client to fractionalize real property. As between spouses, suitable regard should be given to converting all survivorship tenancies to tenancies-in-common. At the death of the first spouse, the bypass trust can then be funded with discounted undivided interests maximizing the use of the shelter. The funding of the QTIP share with an undivided interest will permit a discount in connection with the valuation of that interest at the death of the survivor.

Fractionalizing a residence between spouses who both live there should not cause any transfer tax difficulty, but fractionalizing a residence between a donor-parent and a child may cause inclusion in the parent’s estate as a retained interest under Code Section 2036 (a)(1).

As noted at the beginning, annual exclusion gifts of undivided interests in real property leverage the exclusion and depress the value of the interest retained. Transfers of undivided interests in real property to minors can be made through the Virginia Uniform Transfers To Minors Act.

With regard to the assessment of the tax risks associated with gifts of “sliver” undivided interests by the dying client, note should be taken of Estate of Murphy v. Commissioner, a much criticized case in which the Tax Court disallowed a minority discount for a 49.6 percent stock interest where decedent had given 9 percent of the stock to each of two children eighteen days before her death (reducing her holdings from 51.4 to 49.6 percent). In direct opposition to the Estate of Murphy decision and without mentioning it, the Tax Court in Estate of Frank v. Commissioner permitted a discount (combined 45%) for decedent’s 32.14 percent block of stock remaining after he gave 18.16 percent of the stock to his wife just two days before his death, the transfers having been effected through a power of attorney held by decedent’s son. The Frank case involved transfer of an 18.16 percent block rather than a 1.8 percent block of stock as in Murphy; however, it is difficult to see how this main distinguishing fact could produce opposite results. Since at worst death-bed gifts of undivided interests will be respected even if the discounts are disallowed, and at best discounts will be allowed on both the gifts and decedent’s retained undivided interest, it is hard to see any downside with regard to this manner of gifting.

Where each spouse transfers a fractional interest in the family home to such spouse’s qualified personal residence trust (QPRT), the value of the gift (the remainder interest) will be entitled to a discount. A single homeowner can get the same result by establishing two (or more) QPRTs each to contain a fractional interest in the home.

Enhanced discounts for partnership interests in a family limited partnership (FLP) would be available where the FLP owns an undivided interest in real property as a tenant-in-common.

In making fractional interest gifts with encumbered property, the amount of the encumbrance may be deducted.

Finally, planning consideration should be given to maximizing the number of co-tenants and decreasing the percentage retained as these factors may influence the size of the discount permitted.

VII. Conclusion

The law is clear at present that a valuation discount is properly applicable both to the gift of an undivided interest in real property and to the valuation of an undivided interest in real property remaining in decedent’s estate at death. Discounts in the 15 to 20 percent range involve little tax risk. It is expected that experienced discount appraisers familiar with the disadvantages of tenancies-in-common, including forced access and forced sale issues, will be utilized more frequently in the future resulting in increased discounts.

Transfer tax planning using fractional interest gifts is relatively inexpensive, simple and quick to implement and easy to explain and understand. Such planning is appropriate in a wider range of situations than more sophisticated techniques. As a result, use of and uses for this flexible planning tool will multiply.

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ENDNOTES

1. As used here, an “undivided interest” refers to an interest in a tenancy-in-common and is used interchangeably with “fractional interest.” Under Virginia law, such an interest generally is created by a deed to two or more grantees without survivorship language, see VA. CODE ANN. § 55-20 (Michie 1995), or by will or by operation of law, see, e.g., VA. CODE ANN. § 20-111 (Michie 1995). Residuary beneficiaries under a will take real estate passing by the residuary clause as tenants-in-common (“co-tenants”). A typical gift deed creating a tenancy-in-common follows as Exhibit 1. Undivided interests need not be equal.

2. There are, of course, disadvantages with a tenancy-in-common. These disadvantages account in part for the valuation discount and will be noted elsewhere in this article.


6. 73 T.C.M. (CCH) 2615, T.C. Memo 1997-180.


8. 75 T.C.M. (CCH) 1758, T.C. Memo 1998-59.

9. Even though the size of the discount in Williams is an apparent aberration, the emphasis by the court on lack of control and the historic difficulty of selling an undivided interest in real property is typical of recent cases. See, e.g., Estate of Cervin v. Commissioner, 68 T.C.M. (CCH) 1115, T.C. Memo 1994-550 (20% discount). For a case permitting a combined discount of 30 percent for fractional interests and lack of marketability in valuing gifts of undivided interests in New York real property, see LeFrak v. Commissioner, 66 T.C.M. (CCH) 1297, T.C. Memo 1993-526.


12. Hall, supra note 7, at 26; see generally John Bogdanski, ESTATE TAX VALUATION, 5-4 to 5-7 (1996).


14. Williams, supra note 8.


Section 2512 provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. The value of a particular kind of property is not the price that a forced sale of the property would produce.


17. VA CODE ANN. § 8.01-83 (Michie 1992).

18. Thrasher v. Thrasher, 202 Va. 594 (1961); Shotwell v. Shotwell, 202 Va. 613 (1961) (both de-
cided under a prior version of VA. CODE ANN. § 8.01-83, subsequent changes to which would not effect the holding in either case). In Shotwell the minority co-tenant held a 1/8 interest.

19. Virginia Code sections related to partition are found at VA. CODE ANN. §§ 8.01-81 to 8.01-93 (Michie 1992); those related to judicial sales generally at VA. CODE ANN. §§ 8.01-96 to 8.01-113 (Michie 1992).


21. After findings that partition-in-kind cannot be conveniently made and that the interests of the co-tenants will be promoted by a sale of the entire property. VA. CODE ANN. § 8.01-83 (Michie 1992).

22. Such costs may include filing fees, service fees, fees of the commissioner in chancery, court reporter fees, bond premiums, title fees, grantor’s tax, commissioner of accounts fees, commissioner of sale fees, attorneys fees, appraisal fees, surveyor fees, advertising fees and the like and may exceed 7% or more of the value of the property.

23. Even though in Virginia the partition process can be sped up by referral to a commissioner in chancery, and the length of time involved may vary from jurisdiction to jurisdiction, a contested partition suit involving discovery would require at least nine months before the sale is authorized, followed by a period when bids are received, one is accepted and a confirmation decree entered. If an appeal is taken from such decree, then the process would involve another year at least. It would be hard to imagine a contested partition action including an appeal being completed in less than two years in Virginia. A review of recent reported partition cases involving appeals indicates that the time lapse may be even greater: Upton v. Hall, 225 Va. 168 (1983) remanded for further proceedings (four years until ruling of Supreme Court of Virginia); Quillen v. Tull, 226 Va. 498 (1984) (in excess of four years until Supreme Court affirmance of trial court decree); Sensabaugh v. Sensabaugh, 232 Va. 250 (1986) rev’d and remanded (seven years until ruling); and Smith v. Woodlawn Constr. Co., 235 Va. 424 (1988) rev’d and remanded (in excess of nine years). Because of delay potential, logically any purchaser in a partition action would make the contract offer con-
36. See Estate of Berg v. Commissioner, 61 T.C.M. (CCH) 2949, T.C. Memo 1991-279, for a similar result.

37. 64 T.C.M. (CCH) 284, T.C. Memo 1992-425.

38. See Mooneyham v. Commissioner, 61 T.C.M. (CCH) 2445, T.C. Memo 1991-178, for a similar result.

39. 84 F.3d 195 (5th Cir. 1996). For a thoughtful discussion of this case see Farhad Aghdami, "Fractional Interest Discount Opportunities After Estate of Bonner," 13 Tr. & EST. NEWSL. 2 (Fall 1996).

40. Bogdanski, supra note 12, at 5-12.

41. Covey, supra note 5 at 131.

42. Id., at 134. Assuming the appraisal of the overall property is accurate (and the discount taken is less than 50 percent), no penalty for substantial transfer tax valuation understatement (value per return 50 percent or less of correct value) under I.R.C. § 6662 (1986)(as amended), would be expected.

43. Such as valuation of limited partnership ("FLP") and limited liability company ("LLC") interests.

44. Hall, supra note 7, at 27-28.

45. Where the fractional interests are large enough and the values high enough to justify the expense, it is the writer's current practice to hire a real estate appraiser to appraise the overall value of the property and a separate appraiser for the discount. The last two discount appraisals obtained appraised the discounts of undivided interests at 40 percent and 45 percent.


47. Assuming no asset protection or divorce issues are present.

48. For reasons set forth in note 29, the marital deduction share should not be funded with a partial interest created out of an unfractionalized asset at the time of funding. Assuming no fiduciary duty is violated, creation of a fractional interest out of an unfractionalized QTIP asset during the administration of the QTIP trust, such as by distributing a "sliver" interest from the QTIP to the surviving spouse, would permit discounting of the partial interest retained in the QTIP at the survivor's death.


50. Where the property to be fractionalized has a low basis for income tax purposes, an analysis comparing estate tax savings to the capital gains tax resulting from the loss of the basis "step-up" under I.R.C. § 1014 (1986) should be prepared in connection with advice concerning gifts in excess of the annual exclusion.


52. 60 T.C.M. (CCH) 645, T.C. Memo 1990-472.

53. See, e.g. Bogdanski supra note 12, at 4-81 to 4-82; Richard Covey, "Sophisticated Estate Planning & Drafting Technologies," 38-41 (Oct. 16, 1997)(outline available from National Law Foundation). In effect the Murphy court disregards the repeal in 1981 by amendments to I.R.C. § 2035 of the three year rule.

54. 69 T.C.M. (CCH) 2255, T.C. Memo 1995-132.

55. Despite Frank, the IRS continues to cite Murphy. See Bogdanski, supra note 12, at 4-84 (suppl.).


57. For a comprehensive treatment of this technique, including comparisons of amounts of taxable gifts where sizes of the fractional interests transferred and the duration of the QPRTs vary, see Gilliand, "Fractional Interests Make a Better QPRT,"
58. LeFrak, supra note 11, at 1301. The use of encumbered property is problematic. At the least, the principal portion of the mortgage paid by donor in excess of donor’s proportionate share of the property would constitute a further gift.

59. See generally Braswell, supra note 3, at 284.
to minimize estate taxes, manage your assets in the
event of your incapacity, avoid probate and preserve
your privacy. Since you are each serving as a co-
trustee of your own trust, the proper employer identi-
fication number for John’s trust is his social security
number, and the proper employer identification num-
ber for Elizabeth’s trust is her social security number.

As we discussed, you each have an estate tax
exemption which in 1998 is equal to $625,000. This
amount will increase steadily for the next several
years, until the year 2006, at which time the estate tax
exemption amount will equal $1,000,000. We recom-
mand that you prepare for the increase in the estate
tax exemption by funding each of your trusts as
closely as possible to the $1,000,000 level. Not only
will this ensure that you have taken full advantage of
the estate tax exemption available to each of you in
future years, it also allows for the management of
your assets by your successor trustees in the event of
your incapacity.

Below you will find the following:
I. Schedule of Assets - Before Funding
   Trusts
II. Retitling Recommendations
III. Schedule of Assets - After Funding Trusts

I. SCHEDULE OF ASSETS - BEFORE FUND-
   ING TRUST

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>John’s IRA --Traditional(3)</td>
<td>$600,000</td>
</tr>
<tr>
<td>John’s IRA -- Roth(3)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Virginia Residence(net)(2)</td>
<td>$350,000</td>
</tr>
<tr>
<td>North Carolina Beach Condo(2)</td>
<td>$200,000</td>
</tr>
<tr>
<td>Stocks and Bonds(1)</td>
<td>$200,000</td>
</tr>
<tr>
<td>Life Insurance on John’s Life(3)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Mutual Funds(1)</td>
<td>$250,000</td>
</tr>
<tr>
<td>Partnership Interest(1)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Certificates of Deposit(1)</td>
<td>$50,000</td>
</tr>
<tr>
<td>Installment Note(1)</td>
<td>$25,000</td>
</tr>
<tr>
<td>U.S. Savings Bonds(1)</td>
<td>$25,000</td>
</tr>
<tr>
<td>Checking Account(1)</td>
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</tr>
<tr>
<td>Tangible Personal Property(1)</td>
<td>$40,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$2,000,000</strong></td>
</tr>
</tbody>
</table>
Assets are titled as follows:

(1) Joint tenants with right of survivorship
(2) Tenants by the entirety with right of survivorship
(3) Primary beneficiary = spouse; alternate beneficiary = children

II. RETITLING RECOMMENDATIONS

JOHN'S IRA (Traditional)

John's traditional IRA equals roughly one-third of your combined assets. John will begin taking his required minimum distributions from this account in approximately three years. In determining how John's required minimum distributions will be calculated, John has the option of using his life expectancy and that of a designated beneficiary.

John may name Elizabeth, his revocable living trust or your children as the beneficiary of his traditional IRA. If Elizabeth is the beneficiary of John's IRA, she can elect to roll-over the IRA into an IRA in her own name and defer the payment of income taxes. When Elizabeth reaches the age when she must receive her required minimum distributions, (i.e., April 1 of the calendar year following the calendar year in which she reaches the age of 70-1/2), she can elect to have the distributions calculated based her life expectancy and the life expectancy of a designated beneficiary (i.e., your oldest child). A designated beneficiary will be treated as no more than ten years younger than Elizabeth.

If Elizabeth is the beneficiary of John's IRA, however, John's trust may not contain enough assets to use up all of his available estate tax exemption. With Elizabeth's consent, John could name his revocable living trust as the beneficiary. John can still use Elizabeth's life expectancy to calculate his required minimum distribution. The trust, however, does not have the right to roll-over the IRA into an IRA in Elizabeth's name. If John dies before the required mandatory distributions have begun, distributions from the IRA will have to be paid within a five-year period after John's death or over Elizabeth's life expectancy. If he dies after the required mandatory distributions have begun, the IRA funds must be distributed at least as rapidly as under the method of distribution in effect on the date of John's death.

Since an individual's income tax rates are generally lower than the estate tax rate, it may make sense to have John's trust pay some income taxes on his IRA rather than have Elizabeth's estate pay estate taxes on any IRA funds rolled over to her. Before reaching this conclusion, however, the potential estate tax liability of Elizabeth's estate needs to be determined. Since we cannot predict at this time the size of Elizabeth's estate, or even which spouse will die first, we recommend that John designate Elizabeth as primary beneficiary and John's trust as alternate beneficiary of his IRA. Thus, if Elizabeth survives John, she will have the option of either (i) rolling over the IRA into her own IRA and deferring income taxes; or (ii) disclaiming some or all of the IRA to further fund John's trust and fully utilize his estate tax exemption.

Designating your children as the beneficiaries of John's IRA would enable you to minimize, to the extent possible, the size of the distributions that he will receive from his IRA. John can have the amount of the required distributions calculated based on his life expectancy and your oldest child's life expectancy (subject to the ten-year rule). Upon John's death, the children could elect to receive distributions based on the oldest child's life expectancy and continue the deferment of the payment of income taxes.

Naming your children as the beneficiaries of John's IRA, however, will prevent Elizabeth from having access to these funds if she survives John and needs the IRA assets for her support. Additionally, if John dies first and the amount in the IRA exceeds John's estate tax exemption, estate taxes will have to be paid on the excess amount.

You might consider separating the IRA into several IRAs, one for Elizabeth and one for each of the children. You must separate the IRA, however, before John starts receiving his required minimum distributions. This would allow you to place a significant amount of the IRA assets into an IRA with Elizabeth as primary beneficiary and the trust as the alternate beneficiary. You could then place smaller amounts into IRAs for each of the children. The main benefit of this strategy is that upon John's death, each child could elect to receive distributions based on his or her life expectancy.

IRA (Roth)

In February of 1998, you converted some of the assets in John's traditional IRA to his Roth IRA and you are in the process of converting more assets before April 15, 1999. You are planning to pay the income taxes resulting from the conversion over the tax years 1998 through 2001, rather than solely in 1998.
If John dies before all of the taxes have been paid, Elizabeth, as the surviving spouse, may elect to continue the payment of the taxes over the remainder of the four-year period so long as she is the sole beneficiary of all of John’s Roth IRA’s. Otherwise, any portion of the conversion amount for which taxes have not been paid will be included in John’s taxable income for the tax year that includes his date of death.

In order for any distributions from the Roth IRA to be non-taxable, the amounts in the Roth IRA must be held for a period of five years. This five-year time period begins to run on the first day of the tax year in which the first contribution is made to the Roth IRA. Thus, you could contribute funds anytime from January 1, 1998 to April 15, 1999 and the five-year taxable period begins on January 1, 1998. Since you made your first contribution in February 1998, your five-year taxable period will end on January 1, 2003. This five-year taxable period applies to any funds you may contribute in later tax years. For example, if you contribute funds in the year 2000, you may also withdraw those funds without tax in the year 2003. If John should die before the end of the five-year taxable period and Elizabeth is the beneficiary of the IRA, she will have the right to treat the Roth IRA as her own and the five-year taxable period could continue from the January 1, 1998 date.

John is not required to take any distributions from his Roth IRA during his lifetime. John’s right to defer distributions from the Roth IRA passes to Elizabeth as the surviving spouse if she is the sole beneficiary of the Roth IRA. Thus, if Elizabeth is the beneficiary, the amount in the IRA can continue to grow income tax-free for the benefit of your children. If any other beneficiary is designated to receive the Roth IRA, the account must be distributed (i) by December 31 of the year containing the fifth year anniversary of John’s death, or (ii) over the life expectancy of the designated beneficiary. If you name John’s trust as the beneficiary, the life expectancy of the trust’s oldest beneficiary, most likely Elizabeth, will be used to calculate the distribution.

Until the five-year taxable period ends in the year 2003, Elizabeth should be the primary beneficiary of the Roth IRA with John’s trust as the alternate beneficiary. After that time period, you should determine whether the Roth IRA will be needed to fund John’s trust to take full advantage of his estate tax exemption. If his trust is not fully funded, you should designate John’s trust as the beneficiary of the Roth IRA in order to shield the Roth IRA from estate taxes. Given the significant advantages to designating Elizabeth as the beneficiary of the Roth IRA, you should carefully monitor the assets in John’s trust so that if at a later date you no longer need the Roth IRA to fund John’s trust for estate tax purposes, you can change the beneficiary designation back to Elizabeth.

Virginia Residence

Your residence is encumbered by a $100,000 mortgage. It is our understanding that you may want to refinance this mortgage or obtain a home equity loan in the near future. Under federal law, you may retitle your residence to your trusts without any risk that your lender may exercise its option under the due-on-sale clause as long as you remain the beneficiary of the trusts and continue to occupy your residence.

Since you intend to refinance or obtain a home equity loan on your residence, we recommend that you execute a new deed conveying an undivided one-half interest in your residence to each of you as tenants in common. Lenders are often reluctant and sometimes even refuse to make a loan secured by property which is titled to a trust. Even if the lender does not refuse to make the loan, the lender will impose additional requirements before agreeing to the loan which will complicate settlement. Additionally, some title insurance companies may deny claims on the basis that the properties were transferred into a revocable living trust.

Fortunately, Virginia law provides a method of transferring real property upon death which bypasses traditional probate and allows title to vest automatically upon death. The filing of the will without the appointment of an executor has the same effect as if a deed were recorded. Therefore, you should not be concerned that the failure to re-deed your residence into your trusts will cause unnecessary probate complications upon your death.

Notwithstanding the above, if you decide that you would rather have your residence transferred into your trusts, you should note that the transfer will not trigger any recordation tax in Virginia. Also, the transfer of the property to your trusts will have no impact on your ability to take advantage of the $500,000 capital gain exclusion for married persons who have resided in their homes for two out of the last five years.

North Carolina Beach Condominium

At this time, your beach condominium is free
and clear of any mortgage. If you do not intend to mortgage the property in the future, you should execute a new deed transferring an undivided one-half interest in the property to each of your trusts. Unlike Virginia, North Carolina requires probate proceedings to transfer your property upon death. By transferring title to the property to your trusts now, your estate will not have to undergo ancillary probate proceedings in North Carolina with respect to this property.

You should contact an attorney in North Carolina (or if you prefer, we will contact one for you) to assist in the preparation of a new deed. A North Carolina attorney should prepare the new deed to ensure compliance with North Carolina law and to ascertain any tax consequences resulting from the transfer.

If you intend to mortgage your North Carolina beach condominium, we recommend that you do not transfer the property into your trust until after you obtain the mortgage. As mentioned above, lenders are often reluctant and sometimes even refuse to grant a loan against property which is owned by a trust. If you use the beach condominium as your personal purposes, you can transfer the property to your trust after you obtain the mortgage without requesting the lender’s approval. If you use the beach condominium as a rental property, you must obtain the lender’s approval before retitling the property to your trust. Failing to obtain the lender’s approval before retitling rental property to your trusts could result in the lender exercising its option under the due-on-sale clause.

You should also keep in mind the possibility that the transfer of the property to the trusts may result in a denial of coverage by your title insurance company. You should review your policy and contact your insurance provider to determine whether coverage will continue if you transfer the property. If the insurance provider indicates that such coverage will cease, then you should inquire about the cost of purchasing an “Additional Insured” endorsement.

Stock and Bonds

Your stocks and bonds should be evenly divided between your two trusts to the extent possible. While you do not have to hold the exact same securities in each trust account, you should try to balance the value and type of securities in the accounts. For instance, you do not want to transfer all of the higher risk securities into one of the trust accounts and all of your more conservative investments into the other account because the value of the accounts may increase or decrease disproportionately. Currently, you have a brokerage account which holds the majority of your securities. You also hold a few stock certificates outside of your brokerage account.

With regard to your brokerage account, you should contact your broker and instruct him or her to establish a new account in the name of each of your trusts. Your broker will probably want to see certain pages of your trusts in order to verify that the trusts are valid, to ascertain the trustees and to determine the extent of the trustees’ powers. Your broker will send you whatever paperwork is necessary to establish the new accounts. Your broker will take care of transferring the stocks and bonds from your existing account to the new trust accounts.

You have two options with respect to retitling the stock certificates that are not in the brokerage account. You can contact the transfer agent for each stock to request a new certificate in the name of one of the trusts, or you can transfer these stocks to your broker to be held in one of the new brokerage accounts and let your broker handle the retitling. If you contact the transfer agent directly, you will bear the responsibility of making sure the new stock certificates are issued properly. Like your broker, the transfer agent will probably want to see certain pages of your trusts in order to verify that the trusts are valid, to ascertain the trustees and to determine the extent of the trustees’ powers.

The appropriate wording for retitling your brokerage account and the stock certificates to John’s trust is:

John Jones Trust dated October 15, 1998,
John Jones and Elizabeth Jones, Trustees,
either of whom may act independently.

The appropriate wording for retitling your brokerage account and the stock certificates to Elizabeth’s trust is:

Elizabeth Jones Trust dated October 15, 1998,
Elizabeth Jones and John Jones, Trustees,
either of whom may act independently.

Life Insurance

John should be the owner of the life insurance policy insuring his life and his trust should be designated as the beneficiary of the policy upon his death as follows:

If a life insurance company requires you to identify the specific trustees, identify the trustee(s) who will serve following John's death.

Designating John's trust (rather than Elizabeth or your children) as the beneficiary of your life insurance policy will allow John to further fund his trust for estate tax purposes and ensure that, upon the death of the second of you, your children or other beneficiaries will receive the proceeds in accordance with the trust arrangements you have made on their behalf.

**Mutual Funds**

You should transfer $175,000 of your mutual funds into Elizabeth's trust and the balance into John's trust. The greater value to Elizabeth's trust will compensate for the $100,000 of life insurance insuring John's life which will fund his trust upon his death. If your mutual funds are held in your brokerage account, you should contact your broker and instruct him or her to transfer your holdings into the new brokerage accounts registered in the names of your trusts. Your broker will send you any paperwork necessary to complete the transfer.

If you deal directly with the transfer agent for your mutual funds, you should request the transfer agent to retitle the mutual funds into the names of your trusts. The transfer agent will probably want to see certain pages of the trusts in order to verify that the trusts are valid, to ascertain the trustees and to determine the extent of the trustees' powers under the trusts.

The appropriate wording for retitling the mutual funds to your trusts is the same as for retitling the stocks and bonds to your trusts.

**Partnership Interest**

John owns a fifteen percent (15%) interest as a limited partner in a limited partnership. You should transfer this interest into John's trust. The partnership agreement requires the general partner to approve any transfer of your partnership interest. You should contact the general partner of the limited partnership and request his or her assistance in assigning your limited partnership interest to your trust.

The appropriate wording for the assignment of John's partnership interest is:

John Jones Trust established October 15, 1998, John Jones and Elizabeth Jones, Trustees, either of whom may act independently.

**Certificates of Deposit**

You should fund Elizabeth's trust with the certificates of deposit ("CDs") in order to balance the assets in her trust with John's trust since John's trust is funded with John's interest in the partnership. One option is to retitle the CDs into Elizabeth's trust by completing new signature cards which change the title to both of you as trustees of Elizabeth's trust. The appropriate wording for retitling the CDs to Elizabeth's trust is as follows:

Elizabeth Jones Trust dated October 15, 1998, Elizabeth and John Jones, Trustees, either of whom may act independently.

The other option is to designate Elizabeth's trust as the "Pay on Death" or "P.O.D." beneficiary of the CDs. The appropriate wording for designating Elizabeth's trust as the P.O.D. beneficiary of the CDs is as follows:


Please note that before you change the title to your CDs, you should ask the bank whether the change in title will trigger any forfeiture of interest. If so, you should wait until the CDs mature before retitling them to Elizabeth's trust.

**U.S. Savings Bonds**

Your savings bonds are titled in both of your names as joint tenants with right of survivorship with one-half of the bonds registered with John's social security number and one-half of the bonds registered with Elizabeth's social security number. Title to the bonds should be changed in order to ensure that they pass into the trusts and do not pass automatically to the surviving spouse. Accordingly, you should remove Elizabeth's name on the bonds which are registered with John's social security number and, likewise, remove John's name on the bonds which are registered with Elizabeth's social security number. The spouse whose name remains on the bond should then designate his or her trust as the P.O.D. beneficiary of the bonds or retitle the bonds into his or her own trust. Retitling the bonds to the trust will not trigger the recognition of deferred income on the bond because the owner of the bonds has not changed. The spouse whose social security number was originally assigned to on the bond is considered the owner for income tax purposes.

The appropriate wording for designating John's trust as the P.O.D. beneficiary is as follows:

The appropriate wording for designating Elizabeth’s trust as the P.O.D. beneficiary is as follows:


**Installment Note**

Five years ago, you loaned money to one of your children to establish her own business. She signed a promissory note agreeing to pay the loan back over 15 years. You are both the payees of the note. You should endorse an undivided one-half interest in the installment note to each of your trusts as follows:

As to an undivided one-half interest,
pay to the order of John Jones Trust established October 15, 1998,
John Jones and Elizabeth Jones, Trustees, either of whom may act independently

As to an undivided one-half interest,
pay to the order of Elizabeth Jones Trust established October 15, 1998,
Elizabeth Jones and John Jones, Trustees, either of whom may act independently.
After you insert this wording, you should sign and date the endorsement.

**Checking Accounts**

You should continue to own your checking account as joint tenants with right of survivorship. The relatively small amount of cash that you maintain in this account will not be needed to fund your trusts for estate tax purposes. Changing the title of your checking account will complicate the direct deposit arrangements you presently have for your pensions and your government benefits. The account will pass by right of survivorship the surviving spouse upon the death of the first spouse to die without any probate complications. The checking account will be a probate asset in the estate of the surviving spouse. Therefore, after the first spouse dies, the surviving spouse should designate his or her trust as the P.O.D. beneficiary of this account to avoid probate upon the second death. We will be happy to prepare such an assignment for you.

**Tangible Personal Property**

In general, it is not necessary to transfer title to your tangible personal property (e.g., clothing, jewelry, household goods, personal effects and automobiles) to your trusts while both of you are living if these assets are not needed to fund your trusts for estate tax purposes. You should write a letter of instructions to your executor indicating how you would like specific items (not otherwise specifically bequeathed) distributed upon your death. This letter must describe the items and intended beneficiaries with reasonable certainty and be signed by you. It is not necessary for your letter to be witnessed or notarized. You may alter or amend this letter of instructions at any time without having to modify your will or trust. When the first spouse dies, we recommend that the surviving spouse assign his or her interest in the tangible personal property to his or her trust to avoid probate upon the second death. We will be happy to prepare such an assignment for you.

**CONCLUSION**

We strongly encourage you to retile your assets in accordance with the recommendations set forth above, in order to fully maximize the usefulness of the estate planning documents we prepared for you.
### III. SCHEDULE OF ASSETS AFTER FUNDING TRUST

<table>
<thead>
<tr>
<th></th>
<th>John &amp; Elizabeth</th>
<th>John’s Trust</th>
<th>Elizabeth’s Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>John’s IRA -- Traditional(1)</td>
<td>$600,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>John’s IRA -- Roth(1)</td>
<td>100,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Virginia Residence(net)(2)</td>
<td></td>
<td>175,000</td>
<td>175,000</td>
</tr>
<tr>
<td>North Carolina Beach Condo(3)</td>
<td></td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Stocks and Bonds(4)</td>
<td></td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Life Insurance on John’s Life(5)</td>
<td></td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Mutual Funds(4)</td>
<td></td>
<td>75,000</td>
<td>175,000</td>
</tr>
<tr>
<td>Partnership Interest(8)50,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Certificates of Deposit(6) or (7)</td>
<td></td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>U.S. Savings Bonds(7)</td>
<td></td>
<td>12,500</td>
<td>12,500</td>
</tr>
<tr>
<td>Installment Note(8)</td>
<td></td>
<td>12,500</td>
<td>12,500</td>
</tr>
<tr>
<td>Checking Account(9)</td>
<td></td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Tangible Personal Property(9)</td>
<td></td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>750,000</strong></td>
<td><strong>625,000</strong></td>
<td><strong>625,000</strong></td>
</tr>
</tbody>
</table>

**Recommended Retitling Measures:**

1. Designate Elizabeth as primary beneficiary and John’s trust as secondary beneficiary.
2. Deed property to John and Elizabeth as tenants in common.
3. Deed property to the two trusts as tenants in common.
4. Establish brokerage account in the name of each trust and divide as indicated.
5. Designate John’s trust as beneficiary.
6. Reissue in name of trust(s).
7. Designate trust(s) as P.O.D. beneficiary.
8. Endorse to trust(s).
9. No change now. After first spouse dies, designate trust of surviving spouse as P.O.D. beneficiary for checking account and assign tangible personal property to trust of surviving spouse.
1. The Internal Revenue Service recently issued revised Proposed Regulations regarding the criteria for designating a trust as the beneficiary of an IRA. Revised Prop. Treas. Reg. Section 1.401(a)(9)-1. The revised Proposed Regulations modify Section 1.401(a)(9)-1 of the Treasury Regulations to allow the beneficiaries of a revocable living trust to be treated as a designated beneficiary of the IRA if: (i) the trust becomes irrevocable upon the employee’s death; (ii) the trust is valid under state law; (iii) the beneficiaries of the trust are identifiable and; (iv) a copy of the trust agreement is provided to the plan administrator or certain trust certification requirements are satisfied.


3. If Elizabeth has more than one designated beneficiary, the designated beneficiary with the shortest life expectancy, not to exceed ten years, will be calculated along with her life expectancy. Prop. Treas. Reg. Section 1.401(a)(9)-1(E) Q&A E-5, and Prop. Treas. Reg. Section 1.401(a)(g)-2 Q&A 6. In order to take advantage of each of the children’s life expectancy, Elizabeth could separate the IRA into three accounts naming each child as the designated beneficiary of a different account.


5. I.R.C. Section 401(a)(9)(B)(ii) and (iii).


7. John’s children would need to choose to receive the benefits over the oldest child’s life expectancy no later than December 31st of the calendar year following the calendar year of John’s death. I.R.C. Section 401(a)(9)(B)(iii).


13. Id.

14. Prop. Treas. Reg. Section 1.408A-6 Q&A 7. Please note that if Elizabeth had her own Roth IRA with a five year taxable period ending earlier then John’s, the earlier time period from her own Roth IRA would apply to the Roth IRA she receives from John. Id.

15. I.R.C. Section 408A (c)(5)(A).


17. I.R.C. 401 (a)(9)(B)(ii) and (iii).


19. See Jonathan Rivin and Thomas J. Stikker, “Title Insurance for Estate Planning Transfers,” Probate & Property, May/June 1998. The authors wish to express their thanks to Richard A. Holdeman, Esq. for bringing this article to their attention.


22. See I.R.C. Section 121 (as amended by 1997 Taxpayer Relief Act) and Priv. Ltr. Rul. 8006056; Priv. Ltr. Rul. 8007050; Priv. Ltr. Rul. 8025027 (interpreting previous Code Sec. 121).


25. In 1995, Virginia Code Section 64.1-45.1 was enacted to allow a will to incorporate by reference a written statement or list executed before or after the execution of the will which disposes of specific items of trust tangible personal property. In 1997, a similar provision was enacted for trusts. Va. Code Ann. Section 55-7.2.
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