NEWSLETTER Trusts and Estates

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Message from the Chair

Vanessa Stillman

On behalf of the Board of Governors of the Virginia State Bar Trusts and Estate Section, I am pleased to introduce the Summer 2022 edition of our Trusts and Estates Newsletter.

This issue includes four interesting and topical articles which we hope are helpful to your practice. First, Cynthia L. Brown of Frederick J. Tansill & Associates, LLC, presents "The ABCs of GST". This article reviews the estate/gift tax and generation-skipping transfer (GST) tax consequences of lifetime gifts and explains the basic principles of reporting lifetime gifts that are or may be subject to the GST tax. The article covers both direct skip gifts and indirect skips and other transfer in trust. Our readers will appreciate that Cynthia is able to explain the complex and intricate GST gift tax regime in such a clear and understandable manner.

With the recent increase in interest rates and the expectation of a further increase in the near future, the estate planning techniques that attorneys have been employing for the past several years may no longer be appropriate or the best use of a client's unified estate and gift tax exemption. In our second article, "Estate Planning Techniques for Increasing Interest Rates", Ellis Pretlow of Kaufman & Canoles, P.C. addresses techniques that can be employed successfully in a high interest rate environment.

Stephen W. Murphy, Michael H. Barker, Jodie Herrmann Lawson and Hunter M. Glenn of McGuireWoods LLP have collaborated to bring us their article, "Virginia Supreme Court: Arbitration Clauses in Trusts are Not Enforceable Against Beneficiaries". In this article, the authors analyze the recent Virginia Supreme Court case of *Boyle v. Anderson*, and discuss the Court's review of whether a settlor can require that trustees and beneficiaries submit disputes to arbitration as an alternative to litigation.

Finally, Glenn Nozick has contributed his article, "What Do I Do with This Stamp or Coin Collection? Advice for Beneficiaries and Collectors", which provides practical tips on advising clients regarding inherited collectibles with a focus on stamp collections. Glenn Nozick is Assistant General Counsel of a corporation headquartered in Northern Virginia and a long-time appraiser for the American Philatelic Society. His article discusses how to preserve a collection, how to get it appraised, options for disposal, and perhaps most importantly, what your client can do today to help their heirs.

We sincerely hope you enjoy the articles included in this issue of the Newsletter. I extend my gratitude to Brooke C. Tansill, our Newsletter Editor, for her hard work in sourcing authors, editing, and producing this edition of our Newsletter. We would also like to thank the authors who generously offered their time and expertise to serve our Section.

The Board of Governors encourages anyone interested in contributing to future Newsletters to contact us, and we welcome your suggestions for future Section activities and CLE topics. Please feel free to contact me or any member of the Board of Governors with your thoughts and suggestions.

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The ABCs of GST

by Cynthia L. Brown

The generation-skipping transfer (GST) tax regime is complex and intricate, and entire books have been written to explain the workings of the tax itself and recommended planning strategies to take advantage of the GST exemption ($12.06 million under current law, the same amount as the estate/gift tax exemption). The modest aim of this short article is to cover the basic principles of reporting (and when not to report) a few common types of lifetime gifts that are or may be subject to the GST tax on Form 709, and to briefly describe the estate/gift tax and GST tax consequences of those gifts. It is intended for practitioners who are generally familiar with the estate and gift tax rules but are unfamiliar with the GST tax and the relationship between the exemptions and exclusions available against the estate/gift tax and those available against the GST tax.

Section One of this article covers direct skip gifts; Section Two covers indirect skips and other transfers in trust. In all of the examples discussed in both sections, it is assumed that the donor has made no gifts in the same calendar year apart from the gift described, has sufficient exemption available to shelter the reported transfer from both gift and GST tax, and is not splitting gifts with a spouse.

Section One - Direct Skips

Direct skip gifts are reported on Part 2 of Schedule A of Form 709. A direct skip is a transfer of property that is: (1) subject to the gift tax; and (2) made to a skip person. A skip person is an individual deemed to be two or more generations younger than the donor, or a trust in which all of the interests are held by skip persons. (Correspondingly, a non-skip person is any donee that is not a skip person.) If the donee is a descendant of a grandparent of the donor, the donee's generation is determined by comparing the number of generations between the grandparent and the donor and the number of generations between the grandparent and the donee. Thus, a donor's sibling is in the same generation as the donor, a donor's child, niece or nephew is one generation younger than the donor, and a donor's grandchild, grandniece or grandnephew is two generations younger than the donor. The donor's spouse is assigned to the donor's generation, and the spouse of a lineal descendant of the donor is assigned to the same generation as the descendant to whom the spouse is married. An important exception to the generation assignment rules for relatives is the "predeceased parent" exception. If a lineal descendant of the donor is deceased at the time of the transfer, the deceased descendant's children (and more remote descendants) move up one generation closer to the donor - i.e., if the donor's child is deceased, that child's children (the donor's grandchildren) move up to the level of donor's child and thus are not skip persons. In the case of a donor who has no lineal descendants, the predeceased parent exception can apply to descendants of the donor's siblings, so that, for example, a grandniece or grandnephew is treated the same as a niece or nephew (and therefore not a skip person) if the grandniece's or grandnephew's parent who is the donor's niece or nephew is deceased at the time a transfer to her or him is made.

Unrelated individuals are assigned to a generation based on their age in relation to the donor: individuals born within 12 ½ years after the donor are assigned to the donor's generation; individuals born between 12 ½ and 37 ½ years after than the donor are considered one generation younger than the donor, and individuals born more than 37 ½ years after than the donor are considered two (or more) generations younger than the donor, and are thus skip persons.

One common direct skip is an outright gift to a grandchild. Outright gifts to skip persons qualify for the GST tax annual exclusion under Internal Revenue Code Section 2642(c) as well as for the gift tax annual exclusion. (The amount of both exclusions under current law is $16,000.) So if a donor gives $100,000 to her grandchild, the first $16,000 qualifies for the GST tax (and gift tax) annual exclusion; the remaining $84,000 is a direct skip which uses that amount of the donor's available GST exemption (and the same amount of estate/gift tax exemption).

Gifts to trusts benefitting one or more grandchildren (but no other beneficiaries) are also common direct skips. Such gifts qualify for the GST annual exclusion only if: (1) they otherwise qualify for the gift tax annual exclusion as present interest gifts (e.g., because the grandchild has a withdrawal right, or because the trust is an Internal Revenue Code Section 2503(c) trust for the benefit of a minor which either passes to the minor when he attains age 21 or over which the minor has a withdrawal right at age 21); (2) the trust has only one beneficiary; and (3) the trust is includible in the beneficiary's estate if he dies before receiving all of the trust outright.

Thus, a gift to a trust for the sole benefit of a single grandchild who has a withdrawal right over contributions to the trust, which provides that if the grandchild dies during the trust term the remaining assets are distributed to the grandchild's estate, or which grants the grandchild a testamentary general power of appointment over all of the trust assets remaining at the grandchild's death, is essentially treated the same as an outright gift to the grandchild. If a donor makes a $100,000 gift to such a trust the first $16,000 qualifies for the GST tax (and gift tax) annual exclusion; the remaining $84,000 is a direct skip which uses that amount of the donor's available GST exemption (and the same amount of estate/gift tax exemption).

A gift to a UTMA account or Section 529 plan for the benefit of a grandchild also qualifies for the annual exclusion for both gift and GST tax purposes.

Transfers to other types of direct skips to trusts do not qualify for the GST annual exclusion, whether or not they qualify for the gift tax annual exclusion. For example, a $100,000 gift to a trust for the benefit of five grandchildren, all of whom have withdrawal rights over a proportionate share of the contribution, qualifies for the annual exclusion for gift tax purposes. Thus the first $90,000 ($16,000 times 5) of the transfer is exempt from gift tax and only $10,000 of the donor's gift/estate tax exemption is utilized, but the entire $100,000 transfer is a direct skip subject to the GST tax and utilizes that amount of the donor's GST exemption. A $100,000 gift to a trust for the benefit of five grandchildren, none of whom have withdrawal rights over contributions to the trust, uses $100,000 of both of the donor's exemptions - estate/gift and GST.

Direct skip gifts in an amount less than the annual exclusion and made in a form that qualifies for the annual exclusion (such as a $10,000 outright gift to a grandchild) do not use any of the donor's estate/gift or GST exemption and need not be reported on Form 709. Also, transfers which benefit skip persons such as a donor's grandchild but which qualify for the education exclusion (for direct payment of tuition to an educational institution) or the medical expense exclusion (for direct payment of medical expenses to a medical care provider) do not use any gift or GST exemption and need not be reported on Form 709.

A donor's GST exemption is automatically allocated to the taxable portion of any direct skip gifts (i.e., the amount in excess of the GST annual exclusion, if applicable) unless the donor elects out of automatic allocation on a timely filed Form 709 by checking the appropriate box on Part 2 of Schedule A.

Section Two - Indirect Skips and Other Transfers in Trust

Part 3 of Schedule A is used to report gifts to trusts that are not direct skips (because some of the trust beneficiaries are non-skip persons) but from which a GST transfer may occur in the future (for example, when a distribution from that trust is subsequently made to a skip person). While direct skip gifts are relatively straightforward in terms of their reporting requirements and tax consequences, "indirect skips and other transfers in trust" reportable on Part 3 are less so.

An indirect skip is defined in Internal Revenue Code Section 2632(c) as a transfer (other than a direct skip) to a GST trust. A GST trust is defined in the same Code section as a trust from which a generation-skipping transfer could occur in the future (for example, a pot trust allowing current distributions to the donor's children and grandchildren), subject to six exemptions. Those exemptions, also listed in the same Code section, will not be covered in detail here except to note that their purpose is to exclude from the definition of a "GST trust" those trusts which are not primarily intended to benefit skip persons and from which substantial generation-skipping transfers are relatively unlikely to occur. For example, one exemption covers trusts providing that more than 25% of the trust corpus must be distributed to, or may be withdrawn by, one or more individuals who are not skip persons on or before such individuals attain age 46, and another exemption covers certain charitable split-interest trusts. Gifts to trusts which are not direct skips and from which a generation-skipping transfer may occur in the future, but which are not indirect skips as defined above, are also reported on Part 3.

A donor's GST exemption is automatically allocated to indirect skips unless the donor opts out of automatic allocation on a timely filed Form 709. Automatic allocation does not apply to gifts in trust that are not indirect skips, but a donor may choose to allocate exemption to such gifts by filing Form 709, even if such gifts are not otherwise required to be reported because they are covered by the annual exclusion.

The examples below illustrate the tax consequences of a few types of gifts reportable on Part 3 of Schedule A.

Example 1. A donor gives $10,000 to a trust benefitting his daughter. Distributions may be made to or for the benefit of the daughter until she attains age 35, at which point the remaining trust assets pass outright her. If the daughter dies before reaching age 35, the remaining assets are distributed to her then living descendants, per stirpes. The daughter has a withdrawal right which qualifies contributions to the trust for the gift tax annual exclusion.

This gift is not required to be reported on Form 709 since it is less than the annual exclusion amount. Although a generation-skipping transfer from this trust could occur if the daughter dies before reaching age 35 and trust assets pass to her descendants, this is not a GST trust because it meets one of the exceptions listed in Code Section 2632(c). Accordingly, the donor's GST exemption is not automatically allocated to this gift and if the donor does not affirmatively allocate exemption on a timely filed Form 709, GST tax will be imposed on any future transfers from the trust to the daughter's descendants. This is probably a risk that is worth taking given the actuarial unlikelihood of an individual's dying before age 35 (assuming of course that the individual is not in poor health), but if the donor is very unlikely to make other use of his GST exemption, it may be worth filing Form 709 in order to allocate GST exemption to the transfer.

This gift uses none of the donor's estate/gift tax exemption since it is less than the annual exclusion amount. If the donor wishes to ensure that future distributions from the trust are not subject to GST tax, he will need to file Form 709 and allocate $10,000 of GST exemption to the gift.

Example 2. The facts are the same as in Example 1, except that the amount of the gift is $100,000.

Form 709 is required in this case since the gift amount exceeds the annual exclusion. The donor may (or may not) choose to allocate GST exemption to the gift, taking into account the same factors noted above.

This gift uses $84,000 of the donor's estate/gift tax exemption. If the donor wishes to ensure that future distributions from the trust are not subject to GST tax, he will need to file Form 709 and allocate $100,000 of GST exemption to the gift.

Example 3. The facts are the same as in Example 1, except that the trust does not provide for distribution of all of the trust assets to the daughter when she reaches age 35 but instead lasts for her lifetime with the remaining trust assets passing to her descendants at her death.

No Form 709 is required in this case since the amount of the gift is less than the annual exclusion. However, this trust is a GST trust within the meaning of Code Section 2632(c) and thus this gift is an indirect skip to which the donor's GST exemption is automatically allocated. The donor may choose to file Form 709 in order to opt out of automatic allocation (perhaps because he is reasonably sure that all of the trust assets will likely be distributed to or for the benefit of the daughter during her lifetime, leaving nothing remaining to pass to her descendants at her death) or simply to create a paper trail documenting the amount of GST exemption he has used.

This gift uses none of the donor's estate/gift tax exemption since it is less than the annual exclusion amount. There will be an automatic allocation of $10,000 of the donor's GST exemption to the gift unless he opts out of automatic allocation on a timely filed Form 709.

Example 4. The facts are the same as in Example 3, except that the amount of the gift is $100,000.

Form 709 is required in this case, and GST exemption is automatically allocated unless the donor chooses to opt out of automatic allocation.

This gift uses $84,000 of the donor's estate/gift tax exemption. There will be an automatic allocation of $100,000 of the donor's GST exemption to the gift unless he opts out of automatic allocation on a timely filed Form 709.

Conclusion

Hopefully this article has been helpful in explaining the basic principles of reporting GST transfers on Form 709 and the relationships between the estate/gift tax exemption and annual exclusion and the GST tax exemption and annual exclusion. More detail about the mechanics of reporting such transfers can be found in the IRS instructions for Form 709. ⚜

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Estate Planning Techniques for Increasing Interest Rates

by Ellis Pretlow

With the recent increase in interest rates and the expectation of a further increase in the near future, the estate planning techniques that attorneys have been employing for the past several years may no longer be appropriate or the best use of a client's unified estate and gift tax exemption.

Section 7520 Rate

Many estate planning techniques operate by dividing ownership in an asset into an income or annuity interest (either based on a life expectancy or a term of years) and a remainder interest. The valuation of both interests is based, in part, on the application of the Section 7520 rate, which is published by the IRS monthly.[1]

The Section 7520 rate for July 2022 is 3.6%; the last time the Section 7520 rate was that high was in November of 2018, but it quickly fell back to 2% by the end of 2019. Prior to then, the last time the Section 7520 rate was 3.6% or higher was March of 2008. Needless to say, estate planning has been focused on low interest rate planning for over a decade. Now is the time to consider what tools can be employed in an environment of increasing interest rates.

In general, when the Section 7520 rate is low, the value of an income or annuity interest is low, and the value of a remainder interest is high. Because of these valuations, estate planning techniques like grantor retained annuity trusts (GRATs), private annuities, and charitable lead annuity trusts (CLATs) are more advantageous from a tax perspective when interest rates are low.

Conversely, when the Section 7520 rate is high, the value of an income or annuity interest increases, and the value of a remainder interest decreases. Because of these valuations, estate planning techniques like grantor retained income trusts (GRITs), charitable remainder annuity trusts (CRATs), and qualified personal residence trusts (QPRTS) are more advantageous from a tax perspective when interest rates are high.

It is important to note that estate planning techniques that do not utilize the Section 7520 rate or any other applicable published rates for the calculation of the values of split interests, such as charitable remainder unitrusts (CRUTs) or charitable lead unitrusts (CLUTs), are not affected by changing interest rates.

GRITs

A GRIT is an estate planning tool in which a grantor contributes property to a trust and retains an income interest for a specified term (either a term of years or his or her lifetime) with the remainder passing to chosen beneficiaries; however, the remainder beneficiaries cannot be "members of the family" of the grantor, which does limit its application as an estate planning strategy.[2] GRITs can be useful, however, for clients who may want to benefit a more distant family member, such as a niece or nephew, or a friend or significant other who does not fall under the statutory definition of "member of the family."[3]

The grantor's retained interest is valued using the Section 7520 rate, and the taxable gift to the remainder beneficiaries equals the value of the property contributed to the GRIT minus the value of the grantor's retained interest. Like GRATs, the grantor must survive the full term of the GRIT for the strategy to be effective as an estate planning tool. The two examples shown below illustrate the effectiveness of a GRIT in a high interest-rate environment:

2-year GRIT	
Example 1: Section 7520 rate of 1%	
FMV of Property transferred into GRIT	$ 1,000,000.00
Value of Income Interest	$ 27,010.00
Value of Remainder Interest (taxable gift)	$ 972,990.00
Example 2: Section 7520 rate of 5%	
FMV of Property transferred into GRIT	$ 1,000,000.00
Value of Income Interest	$ 99,730.00
Value of Remainder Interest (taxable gift)	$ 900,270.00

QPRTs

A QPRT is an estate planning tool in which a grantor transfers a residence (primary or otherwise) into an irrevocable trust for the benefit of the grantor for a term of years with the remainder passing to specified beneficiaries at the end of the term. The calculation of the grantor's retained interest in the residence and the value of the remainder interest that will pass to the beneficiaries of the QPRT is calculated the same way as a GRIT, as discussed above. Additionally, like in a GRIT, the strategy will only work if the grantor outlives the term of the QPRT.[4]

While the technical aspects of a GRIT and QPRT are similar, there are also significant differences. QPRTs have been blessed by the IRS as an accepted transfer tax planning technique in Section 2702, and there are no restrictions on the identity of the remainder beneficiaries like in a GRIT.[5] Additionally, because the trust property is a residence, QPRTs can produce practical challenges.

If the grantor makes any capital improvements to the property during the trust term, those improvements may be additional gifts to the remainder beneficiaries.[6] Following the end of the term of the QPRT, if the grantor desires to utilize the property as a primary or secondary residence, then the grantor must pay fair market rent to the remainder beneficiaries for the use of the property.[7] It is advisable to have a written lease agreement between the remainder beneficiaries and the grantor for such use to ensure that the property is not included in the grantor's estate under IRC §2036. For clients who need to reduce their taxable estates, the payment of rent following the QPRT term is another effective method for passing assets to intended beneficiaries (although this rent will be taxable income to the recipients if they are a different taxpayer than the grantor, i.e. not a grantor trust). It is also important to note: (i) that GST exemption cannot be allocated to the initial gift to the QPRT, making QPRTs ineffective tools for multi-generational planning,[8] and (ii) that the remainder beneficiaries of the QPRT will inherit a carryover basis in the property.[9]

One additional way to leverage a gift to a QPRT is to transfer fractional interests in the residence to two separate QPRTs. The QPRTs can have different terms to reduce the risk that either grantor will not survive the QPRT term, and the contribution of a fractional interest in property to each QPRT will help to support a discount of the fair market value of the portion of the residence being transferred into each QPRT—further increasing the value of the gift that is being made to the remainder beneficiaries with a reduced amount of exemption being utilized to make the transfer.

The example below illustrates the effect of a higher interest rate on the effectiveness of a QPRT:

10-year QPRT	
Example 1: Section 7520 rate of 1%	
FMV of Property transferred into QPRT	$ 1,000,000.00
Value of Income Interest	$ 102,890.00
Value of Remainder Interest (taxable gift)	$ 897,110.00
Example 2: Section 7520 rate of 5%	
FMV of Property transferred into QPRT	$ 1,000,000.00
Value of Income Interest	$ 391,630.00
Value of Remainder Interest (taxable gift)	$ 608,370.00

CRATs

For clients with charitable intent, a CRAT is an estate planning tool in which the grantor contributes property to an irrevocable trust and retains an annuity interest with the remainder going to charity. The grantor receives an income tax deduction upon the creation of the trust equal to the value of the remainder gift to charity, which is calculated using the Section 7520 rate.[10] If the gift to the CRAT is complete at the time of the transfer, then the grantor also receives a gift tax deduction in the amount of the remainder interest passing to charity for the contribution to the CRAT.[11] The term of the CRAT can either be a term of years, not to exceed twenty (20) years, or can be for the lifetime of the trust's beneficiary or beneficiaries (usually the grantor and/or the grantor's spouse).[12] The value of the remainder passing to charity must be at least ten percent (10%) of the value of the property contributed by the grantor to the CRAT, and the value of the annuity payment must be equal to at least five percent (5%) but not more than fifty percent (50%) of the fair market value of the assets on the date they are contributed to the trust.[13] Additionally, when a grantor's interest in a CRAT is measured by his or her lifetime, then the IRS takes the position that in order to receive a deduction for the remainder gift to charity, the probability that the charitable remainder beneficiaries will receive any trust corpus must exceed five percent (5%).[14] In a low interest rate environment, CRATs that pay the annuity payment to a grantor based on the lifetime of a younger individual are unlikely to meet the 10% remainder requirement and 5% probability of exhaustion test.[15] An increasing interest rate provides opportunities to create CRATs for a broader client base.

To be a qualified charitable remainder trust, the trust instrument must satisfy all of the requirements set forth in IRC §664 and the regulations thereunder, and the failure to incorporate one of the mandatory provisions will prevent the trust from qualifying as a CRAT.[16] In 2003, the IRS produced sample forms for CRATs in various Revenue Procedures, which can be used as forms for drafting CRATs for clients.[17]

A CRAT can result in additional tax savings if the grantor contributes a highly appreciated asset to the CRAT, as the CRAT itself is exempt from income tax.[18] It is important to note that while the CRAT itself is exempt from income tax, the annuity payments are taxable to the individual beneficiaries of the CRAT on a tiered system.[19] A CRAT is required to file an IRS Form 5227, Split-Interest Trust Information Return, a substantial portion of which is publicly available, so if there are privacy concerns, then it is advisable to leave identifying information about the donor out of the name of the CRAT. [20]

The following example illustrates an almost $100,000 increase in the charitable deduction for a CRAT with all facts being the same except for an increase in the Section 7520 rate:

Lifetime CRAT for 80-year old with 6% Annuity Payment	
Example 1: Section 7520 rate of 1%	
FMV of Property transferred into CRAT:	$ 1,000,000.00
Present Value of Annuity	$ 474,126.00
Value of Remainder Gift to Charity (Deduction)	$ 525,874.00
Example 2: Section 7520 rate of 5%	
FMV of Property transferred into CRAT:	$ 1,000,000.00
Present Value of Annuity	$ 376,416.00
Value of Remainder Gift to Charity (Deduction)	$ 623,584.00

Applicable Federal Rate

In addition to the Section 7520 rate, the IRS also publishes the applicable federal rate (AFR) monthly, which sets the minimum interest rate that must be charged so that a loan will not be treated as a gift to the recipient of the loan.[21]

The AFR for long-term obligations (over nine years) compounded annually for July 2022 is 3.17%. While this rate is higher than it has been in recent years, it is still lower than commercially available loans and presumably will continue to rise in the future. Because this rate is still relatively low historically, there is still an opportunity to loan family members funds at a lower rate than could be lent to them from a commercial bank and to lock in the current rates to avoid higher interest rates that may lie ahead.

If a client lent his child $500,000 in July 2022, and the loan had a term of ten (10) years with interest compounded and paid annually and a balloon principal payment at the end of the ten-year term, then the son would owe $15,850 in interest every year (assuming he does not pre-pay any of the principal of the loan). Because the current annual exclusion for gifting is $16,000, the client could gift his son $16,000, which the son could then use to pay the interest on the obligation, effectively loaning the money to his son without his son having to pay any interest and without having made a gift.[22] If the client is married, then his spouse could also loan the child an additional $500,000 and make an annual exclusion gift to the child to cover the interest payment.[23] Combined, the parents could lend their child $1,000,000 without the child having to actually pay any interest on the loan. The parents do have to recognize the interest on the loan as income (regardless of whether it is paid or forgiven), but the income tax payment on the interest only serves to further reduce the size of their estates.

Usually clients lend money to their children or grandchildren to buy houses or make other major purchases, but from an estate planning perspective, clients should consider lending funds for their family members to invest. Any investment return over the interest rate charged on the loan would be a tax-free transfer to the family member who was loaned the funds. This technique is not limited to individuals—loans can also be made to or from trusts. To the extent an individual loans money to a grantor trust, then under current law the interest paid by the trust to the grantor is not recognized for income tax purposes because the grantor and the grantor trust are treated as the same taxpayer.

It also is a good time to revisit any existing loans that your clients have made in the past several years. If any loans are coming due in the near future that the client would want to extend, then it may make sense to refinance that obligation now to lock in the current AFR for the loan to avoid a potentially higher rate in the future. ⚜

(Endnotes)

1. IRC §7520; https://www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates.
2. IRC §2702.
3. IRC §2704(c)(2).
4. See Treas. Reg. §20.2036-1(c)(2)(i), §20.2036-1(c)(2)(iv) Ex. 6, §20.2036-1(c)(3), §20.2039-1(e), §20.2039-1(f).
5. IRC §2702.
6. Tax Mgmt. Portfolio 836-3rd: Partial Interests — GRATs, GRUTs, and QPRTs (Section 2702), III. Personal Residence Trust, G. Planning Considerations
7. See PLR 9448035 (ruling that the grantor's fair market rental of property after QPRT term would not cause inclusion in estate of grantor).
8. Treas. Reg. §26.2632-1(c)(2)(i).
9. IRC §1015(a).
10. IRC §170(f)(2)(A)
11. IRC §2522(c)(2)(A).
12. IRC §664(d)(1)(A), §664(d)(2)(A); Treas. Reg. §1.664-2(a)(5), §1.664-3(a)(5).
13. IRC §664(d)(1)(A).
14. Treas. Reg. §20.2055-2(b)(1), §25.2522(c)-3(b)(1).
15. Rev. Rul. 77-374.
16. Treas. Reg. §1.664-1(a)(1)(i); See, e.g., Rev. Proc. 2003-53.
17. Rev. Proc. 2003-55, 2003-31 I.R.B. 242 (inter vivos charitable remainder annuity trust with consecutive interests for two measuring lives).
Rev. Proc. 2003-56, 2003-31 I.R.B. 249 (inter vivos charitable remainder annuity trust with concurrent and consecutive interests for two measuring lives).
Rev. Proc. 2003-57, 2003-31 I.R.B. 257 (testamentary charitable remainder annuity trust for one measuring life).
Rev. Proc. 2003-58, 2003-31 I.R.B. 262 (testamentary charitable remainder annuity trust for term of years).
Rev. Proc. 2003-59, 2003-31 I.R.B. 268 (testamentary charitable remainder annuity trust with consecutive interests for two measuring lives).
Rev. Proc. 2003-60, 2003-31 I.R.B. 274 (testamentary charitable remainder annuity trust with concurrent and consecutive interests for two measuring lives.
Rev. Proc. 2016-42 (alternative CRAT language to satisfy 5% probability of exhaustion test).
Tax Mgmt. Portfolio 865-3rd: Charitable Remainder Trusts, Charitable Gift Annuities, and Pooled Income Funds (Sections 664 and 642(c)(5)), Worksheet 2, Worksheet 2 Sample Charitable Remainder Trust Forms
18. IRC §664(c)(1).
19. IRC §664(b); Treas. Reg. §1.664-1(d)(1).
20. IRC §6104(b); Tax Mgmt. Portfolio 865-3rd: Charitable Remainder Trusts, Charitable Gift Annuities, and Pooled Income Funds (Sections 664 and 642(c)(5)), 1-III. The Basic Structure of Charitable Remainder Trusts, A. Description.
21. https://www.irs.gov/applicable-federal-rates.
22. IRC §2503(b).
23. IRC §2513.

Virginia Supreme Court: Arbitration Clauses in Trusts Are Not Enforceable Against Beneficiaries

by Stephen W. Murphy, Michael H. Barker, Jodie Herrmann Lawson and Hunter M. Glenn

In *Boyle v. Anderson*, No. 210382 (Va. April 14, 2022), the Supreme Court of Virginia addressed an emerging topic in trusts and estates: whether a settlor can require that trustees and beneficiaries submit any disputes to arbitration, rather than allow them to proceed through litigation. This type of clause could be referred to as a "donative arbitration clause," because it exists in a will or trust agreement, as opposed to a more conventional contract between parties.

It might come as no surprise that many settlors and advisors seek to include such a clause in their trusts. Compared to litigation, arbitration can result in savings in time, money and relationships. Importantly, arbitration itself is often private, while litigation is a public affair. Further, arbitration procedures can be specifically tailored to the trust and estate context; for example, an arbitrator might provide that discovery is limited in certain respects or might allow the admission of evidence regarding past practices and family dynamics, which may not otherwise be admissible in open court. Despite such potential benefits, the question remains whether such a clause can be enforced against a beneficiary or a trustee, when such beneficiary or trustee wants to proceed in court.

Under the common law, arbitration clauses were not enforceable. Instead, such clauses are enforceable only by statute.

To date, a handful of states — including Arizona, Florida and South Dakota — have enacted specific statutes to expressly enforce such clauses in trusts. Ariz. Rev. Stat. Ann. § 14-10205; Fla. Stat. Ann. § 731.401; SDCL § 55-1-54.

Absent such a specific statutory provision, state and federal arbitration statutes provide that an arbitration clause is enforceable if contained in a contract or agreement. However, some courts cast doubt on whether an arbitration clause contained in a will or a trust would be enforceable against trustees and beneficiaries.

Against this backdrop appeared the case of *Boyle v. Anderson*, which addressed the enforceability of a trust's arbitration clause under Virginia law.

In this case, Strother Anderson had three children: Sarah Boyle, John Anderson and Jerry Anderson. Jerry predeceased Strother, leaving two surviving children, Claire and Craig.

Strother died in 2011, while a resident of Fairfax County, Virginia. Strother's estate plan included a revocable trust agreement, which named Sarah as the trustee at Strother's death. The terms of the revocable trust provided that three shares were to be created upon Strother's death: a share for Sarah, a share for John and a share for Jerry's children.

The value of the assets of Strother's revocable trust subject to this division were about $1.5 million. Accordingly, each share was to be funded with about $500,000.

Sarah and John's shares were to be held in separate, lifetime trusts for their respective benefit, with each child serving as sole trustee of his or her separate trust. The terms of the child's separate trust provided that the trustee could make distributions for the "health, education, maintenance, or support" of the child during the child's lifetime. And then the child's trust provided that, upon the death of the child, the remaining funds would pass to his or her descendants, or, if none were then living, then to Strother's descendants, to be added to the other shares for those descendants under the revocable trust.

The revocable trust also contained an arbitration provision, which required that any dispute be resolved by arbitration, rather than litigation. The provision read in pertinent part as follows:

> Any dispute that is not amicably resolved, by mediation or otherwise, shall be resolved by arbitration conducted in accordance with the Commercial Arbitration Rules of the American Arbitration Association ("AAA") then in effect.

The arbitration clause included other terms; for example, it clarified that the dispute would be resolved by a single arbitrator and further specified that the arbitrator "shall have the authority to determine whether any such dispute is properly subject to resolution by arbitration."

In a subsequent paragraph, titled "Contesting Beneficiaries Disinherited," the revocable trust further elaborated on Strother's intent: "The Trustor desires that this Trust, the Trust Estate and the Trustees and beneficiaries shall not be involved in time-consuming and costly litigation concerning the administration of this Trust and/or the distribution of its assets."

This particular dispute arose in connection with the administration of John's share. John survived his father, but he died a resident of South Carolina in September 2016, with no descendants and before the revocable trust was divided into each child's separate share. In November 2016, John's wife, Linda Anderson, as administrator of John's estate, brought an action against Sarah in South Carolina court, alleging that Sarah had breached her fiduciary duties as trustee.

The key allegation of Linda's complaint was that Sarah had unreasonably delayed funding the separate shares following Strother's death. Linda alleged that if Sarah had funded those shares in a reasonable amount of time, then John's share would have been available for his benefit, particularly during the illness leading to his death. In fact, Linda argued that John had "unfettered" access to the trust, which would have enabled him to distribute the entire trust to himself. She further argued that "he would have done so," suggesting that John would have terminated his separate trust and distributed the remaining funds to himself. But, as a result of Sarah's delay, Linda alleged, John's share remained in trust, and John's estate was smaller than it should have been.

Moreover, Linda alleged, Sarah's delay had benefited Sarah personally. Because John's share was in trust at the time of his death, pursuant to the terms of the revocable trust, his entire share would pass back to Strother's other living descendants: Sarah and Jerry's descendants. Linda painted Sarah as a bad actor; one of Linda's briefs argued, "Sarah knew John was ill and she delayed distributions to him so that she could take his share when John passed."

Linda's complaint in South Carolina was ultimately dismissed for lack of personal jurisdiction. Linda then brought an action in Fairfax County, Virginia, in 2020. Once the matter was before the Fairfax court, Sarah moved to compel arbitration.

The trial court ruled that the arbitration provision was not binding on Linda, in her role as administrator of a beneficiary of the trust, and it denied Sarah's motion to compel arbitration. Accordingly, the trial court permitted the case to proceed in court. Sarah appealed.

On appeal, the Supreme Court of Virginia upheld the ruling of the trial court. The court first held that, in Virginia, "Access to the courts to seek legal redress is a constitutional right," under the Virginia Constitution (citing the petitions clause, Va. Const. Art. I, Section 12).

The court noted that this right can be waived, so long as a party's waiver meets the requirements of the Virginia Uniform Arbitration Act, which enforces a predispute arbitration clause if contained in a "written contract."

However, the court reasoned, a trust is not a contract, and therefore, any alleged waiver was not effective. The court determined that trusts are not contracts for the following three reasons: (1) trusts do not require the offer and acceptance that is required of contracts, nor do trusts have consideration for formation; (2) the duties of parties to a contract are different than, and are indeed less than, the fiduciary duties of a trustee; and (3) the trust provides for divided ownership, whereas contracts simply require the parties to perform.

The opinion is notable for its short summary of the hallmarks of a trust. In support of its argument regarding the high standard for duties imposed on fiduciaries (compared to the duties imposed on contracting parties), the court quoted Judge Benjamin Cardozo from the famous case *Meinhard v. Salmon* from 1928:

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior…. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

In her briefs, Sarah had relied heavily on *Rachal v. Reitz*, 403 S.W.3d 840, 847 (Tex. 2013), in which the Texas court held that a beneficiary, while not a signatory to a trust, became bound by its terms, through "direct benefits estoppel," thereby making an arbitration clause effective under the Texas Arbitration Act (which makes enforceable an arbitration clause in a "written agreement"). Though the court in *Boyle* did not cite *Rachal* in its opinion, it presumably rejected that argument, as it held that a trust was not a contract or agreement.

The court concluded that because the arbitration clause was not contained in a written contract, it was not enforceable under the Virginia Uniform Arbitration Act (or the Federal Arbitration Act). But the court ended the opinion with the enigmatic statement that the court "express[es] no opinion" on whether an arbitration clause in a trust can be enforced on some basis other than the Virginia Uniform Arbitration Act (or the Federal Arbitration Act). The court did not expand on what those other bases might be, or if it would be receptive to other avenues of making such a clause enforceable.

For the time being, *Boyle* at least clarifies that, in Virginia, a settlor (and likely a testator) cannot require fiduciaries and beneficiaries to resolve their disputes through arbitration. Settlors might have some alternatives to still carry out their wishes, such as providing that the law of a state that does recognize those clauses applies to this question, or building a similar mechanism into the document whereby an independent trustee or trust protector resolves the issue. Meanwhile, trustees administering such a trust might explore changing the situs of the trust to another jurisdiction where the arbitration clause would be enforceable, and beneficiaries who oppose the application of such a clause should be on guard against such attempts to change the situs.

Moreover, even in jurisdictions where donative arbitration provisions are possibly enforceable, settlors should still be mindful of the host of other issues arbitration provisions can create in drafting and administering trusts and estates, as well as their potential tax implications. See, e.g., *Mikel v. Commissioner*, T.C. Memo 2015-64 (April 6, 2015) (with respect to withdrawal rights in an irrevocable trust, the IRS argued in part that when the beneficiaries had to enforce those withdrawal rights in a private forum akin to arbitration, the withdrawal rights were illusory and did not have the tax benefits the settlors intended; on appeal, the Tax Court found that such withdrawal rights were enforceable). McGuireWoods' Fiduciary Advisory Services has been following these cases (see McGuireWoods alert, https://www.mcguirewoods.com/client-resources/Alerts/2021/4/recent-cases-of-interest-to-fiduciaries-april-2021), along with arbitration clauses in investment advisory agreements (see McGuireWoods alert, https://www.mcguirewoods.com/client-resources/Alerts/2018/7/recent-fiduciary-cases-july-2018).

In the meantime, settlors and proponents of arbitration clauses in trusts will have to explore those alternatives to arbitration clauses. It remains to be seen whether the Virginia General Assembly will enact a statute that provides for enforcement of arbitration clauses in trusts. ⚜

What do I do with this Stamp or Coin Collection?

Advice for Beneficiaries and Collectors

by Glenn Nozick

Clients will often seek advice regarding inherited collectibles. As the millennial generation seems to have little to no interest in the passions of their elders, the market for stamps, coins, antique furniture, baseball cards and the like has dropped dramatically. Given the inflexible reality of the law of supply and demand, options are limited with how to address or divest such collectibles. In this article I will focus on how to advise your clients about considerations and options for stamps and coins, my primary areas of expertise, but many of the principles cross collecting boundaries.

Initial Steps Regarding a Collection

If your client inherits a collection, the first thing to do is advise them to protect it – from the elements, from theft and from damage - until they decide what you want to do. Put the collection in a safe place. That sounds obvious, but what does it mean? First, protect it from the elements. Both humidity and heat can ruin the value of stamps and other paper collectibles, as can sunlight. Store the collection in a cool, dry location. Avoid basements, garages, attics, storage units. I have seen wonderful stamp collections ruined by excess humidity – every stamp stuck to the page. If your client is not the collector, and does not know how to properly handle stamps or coins – DON'T! Stamps are very fragile, and the condition of a stamp can greatly affect its value. A fingerprint on the gum, a blunt perforation, and myriad other seemingly minor issues can greatly reduce the value. Similarly, fingerprints or nicks on coins, or a rounded corner on a baseball card can dramatically affect marketability.

A prudent prerequisite to determining what to do with a collection is to know what it is worth – unless your client already know the value they should consider getting an appraisal from an expert. If the collection is part of an estate, a formal appraisal may be required. However, your client can get an appraisal at any time and for any reason, for example, valuation for insurance purposes.

The value of a collection can vary greatly depending on a number of factors, including condition, scarcity, market conditions, popularity of the collecting area, and many other factors. An expert appraiser will understand what your client has, how it fits into today's market and how the condition of the collection affects its value. Given the rapidly changing market, if an appraisal is more than 2-3 years old an update is probably warranted. The cost of an appraisal is sometimes subject to negotiation – it can range from an hourly fee of $50-$450 an hour to a flat rate for the collection, and should be documented. The rate may often depend on the type of collection being appraised – for example a general collection of common stamps might take an hour to complete, while an extensive specialized collection of rarities may take many days; some appraisers charge for travel. It is important to note that you will not get a stamp-by-stamp appraisal; the focus will be on any better individual stamps or sets, and the more common material will be addressed collectively. The majority of coins are valued at a percentage of the value of the silver or gold. The appraiser may not know how much time is required until he or she sees the collection, but be sure you come to agreement on the fee and any other costs before engaging. The appraiser should also be clear about the basis for the appraisal – is it what you can expect to sell the collection for or is it the replacement cost for insurance purposes – these could be very different figures.

What to Do With the Collection? - Options

Now that the collection is safe, and you have a sense of what it might be worth, you can advise your client that what to do becomes a personal decision. Some options include:

1. Keep it. If the collection has sentimental value, and your client doesn't care about turning it into cash, then hold on to it. Maybe their kids or grandkids will be interested. Just remind your client that fewer young people are coming into the hobby, and as a result there are fewer collectors for the same universe of stamps, and consequentially, values are declining.

2. Sell it outright. The advantage is that the transaction takes place, your client gets paid, it is out of the house and they are finished. There is no waiting. If they sell to a dealer, keep in mind a dealer has overhead – and the offered price will reflect those costs. If you sell to a collector, you may get more than wholesale – but a collector may not be interested in the whole collection but only those segments he or she collects.

3. Put it up for auction. Selling at auction is probably the best way to get true "market value" for the collectible, with the least effort required. An auction sale will reflect the supply and demand principle at its finest. The best option in most cases is to sell through a specialized public auction house; e.g., stamps, coins, antiques, etc. Selling through a specialized auction house will give your client's collection the widest visibility to a knowledgeable, targeted audience. For a commission (typically 15-25% of the sales price), the auction house will do the work of separating out the collection into appropriate lots of individual items or groupings, will write descriptions, take photographs and put out a catalogue both in hard copy and on the internet. They will advertise the sale, collect from buyers and ultimately pay your client. Selling at auction takes time, generally 4-6 months from submission to receiving payment. Your client may also consider an online auction site such as EBay. It can be quicker turnaround, but entails a lot more work in scanning and describing the items, wait for payment and shipping. Factoring in the fees for listing, selling and payment engines, the cost is comparable to an auction house commission.

4. Donate it. If the collection is of minimal value, or you are not interested in selling for another reason, your client can donate the collection to a charitable organization (e.g., cub scouts, veteran's organization, etc.) – and may be eligible to take a tax deduction.

I often propose a hybrid solution with collections I am either appraising or purchasing – keep some pieces with sentimental value, sell or donate the rest. Disposing of a collection can be a bewildering experience for the uninitiated, and often compounded with emotion in the context of the passing of a loved one. Hopefully this article has been helpful in laying out choices and providing insight into how to advise your client. ⚜

Glenn Nozick is an attorney in the Washington, D.C. metropolitan area and a long time stamp collector and expert appraiser. He is a member in good standing of the American Philatelic Society and can be reached at glennthen@comcast.net. Feel free to reach out with any questions.

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