NEWSLETTER
Trusts and Estates

Published by the Virginia State Bar Trusts and Estates Section for its members

Volume 25, No. 4 Spring 2023

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 Spring 2023 edition of our Trusts and Estates Newsletter. In this edition of our Newsletter, we bring you two interesting and topical articles which we hope will help enhance your practice.

First, Leslie Bradenham, Partner at Ivins, Phillips & Barker, presents "Estate Planning with Real Estate." In this article, Leslie discusses estate planning for clients gifting personal use real estate, and the benefits of doing so. The article outlines how clients willing to observe certain formalities can incorporate these gifts into their estate plans in order to maximize their use of current estate, gift and GST exemptions without sacrificing liquidity; take advantage of valuation discounts; and transfer beloved family vacation properties to the next generation.

On April 11, 2022, Virginia adopted the Uniform Fiduciary Income and Principal Act ("UFIPA"). In our second article, Douglas Murphy of Baker Hostetler provides a thorough review of the UFIPA by examining the history and prior versions of the Uniform Principal and Income Act, analyzing how the UFIPA adapts to the continued modernization of trusts, and providing practitioners with planning recommendations for the future.

We sincerely hope you enjoy the articles included in this issue of the Newsletter. I extend my gratitude to Emily Martin and Peter Davies for their 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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Estate Planning with Personal Use Real Estate

by Leslie Bradenham

The current all-time high exemption from estate, gift, and generation-skipping transfer (GST) tax, coupled with the potential for it to be reduced by half on January 1, 2026, has resulted in most high-net-worth clients exploring ways to use their entire exemption now, if they haven't used it already. But even for the very wealthy, $12.92 million is a substantial sum with which to part. As a result, many clients have been exploring how to use their exemptions without giving away liquid assets, and real estate is a natural choice. While gifting personal use real estate can be complex and requires careful navigation of transfer tax rules, it can be a good option for some clients.

Gifting the Entire Interest

The Basics

A donor can simply gift her entire interest in a residence outright to one or more children or other beneficiaries. Alternatively, a donor can gift the real estate to a trust for the benefit of children and more remote descendants (or others). Gifts in trust can be beneficial for a variety of reasons, including protection from the claims of creditors, removal of assets from the beneficiaries' taxable estates, and removal of assets from the reach of the generation-skipping transfer (GST) tax. In either case, if the client gifts a 100% interest in mortgage-free real estate, the gift transfer itself is straightforward. A current fair market value real estate appraisal will be required to substantiate the value of the gift, a real estate deed transferring the property to the recipient individual or trust must be prepared and properly recorded, and a gift tax return will be required to report the transaction. Clients should be advised regarding real estate transfer and deed recordation taxes that could apply, but in most states there is an exemption for gift transfers.

Continued Donor Occupancy

If the donor wishes to continue occupying the home, the transaction becomes more complicated. Payment of fair market value rent will typically be required. This is because, pursuant to IRC § 2036, property given away during a client's lifetime will be included in the client's taxable estate if he retains a continued right to the income or enjoyment of the property, whether express or implied. To minimize the risk of this result, if a donor wants to occupy the property, she should enter into a written lease agreement with the donee and pay fair market value rent, as established by an independent appraisal. This appraisal is important not only to substantiate that full value is being paid, and thus no rights are retained that would trigger estate inclusion under IRC § 2036—but also to ensure that the client is not paying too much in rental payments, thereby risking an argument that additional, disguised gifts are being made.

Not only is a formal written lease the best practice for avoiding estate and gift tax issues, it is also an efficient way to transfer additional wealth to beneficiaries. The lease payments are not taxable gifts when made and reduce the value of the donor's estate for estate tax purposes. Moreover, if the real estate was gifted to a trust that is classified as a "grantor trust" for income tax purposes, the rental income received by the trust is not subject to income tax.

While leaseback of the gifted residence is almost always recommended for the reasons discussed above, where the real estate is gifted to a trust for which the grantor spouse is a beneficiary—often referred to as a "Spousal Lifetime Access Trust" or a "SLAT"—rental payments may be unnecessary. The theory is that the grantor spouse's continued use of the property with the beneficiary spouse is a "natural incident to the marital relationship."[1] Therefore, the rent-free use of the property together with the donee spouse after the gift does not itself give rise to an implied agreement that the donor has retained the right to use or enjoy the property.[2] Accordingly, many practitioners feel comfortable that a donor spouse can continue to occupy real estate gifted to a SLAT without paying rent, so long as the donee spouse is living there with the donor.

This, in turn, raises the question of whether, after gifting the property to a SLAT, a grantor spouse *can* pay 100% of the rent for continued occupancy with the donee spouse without making unintended gifts. Where the lease arrangements give the donor spouse the right to exclusive possession and/or the trust agreement does not prohibit a beneficiary, i.e., the donee spouse, from paying rent, this risk is likely small. As such, clients with the resources to do so will often choose to pay rent despite the SLAT structure for the estate planning benefits these payments provide. Those that do not, however, must be advised that, if the donee spouse predeceases the donor, rent will be needed for continued occupancy by the surviving donor spouse to avoid the risk of inclusion for estate tax purposes.

Gifting a Portion of Residential Real Estate

Gifts of Fractional Undivided Interests

A donor need not gift her entire interest in a residence. Dividing the property into *successive* interests, and gifting the remainder interest while retaining a life estate, is precisely what IRC § 2036 is designed to prevent. Gifts of successive interests to family members are further frustrated by IRC § 2702, which values the gift of a remainder interest at the property's full value. A donor can, however, transfer a *concurrent* interest in residence without tripping these provisions. Indeed, this type of transfer is common, and can result in significant transfer tax savings.

Using this technique, the donor will transfer fractional undivided interests in the property to one or more individuals (or one or more trusts for their benefit). Each such transfer to a donee will be made by real estate deed, which must be recorded in the land records. Following the gift, the donor and the donee(s) will own the residence as tenants in common ("TIC").

With TIC ownership, all the cotenants have the right to possess the property, and any cotenant can unilaterally sell, encumber, gift, or devise his or her property interest without the consent of the other cotenants. Importantly, any one cotenant can veto decisions with respect to the parcel as a whole. Each cotenant also has the right to force a partition of the property, which in the case of a single residence will mean a sale of the property and distribution of the proceeds to the cotenants in proportion to the ownership share.

Given these characteristics, the value of the gifted TIC interests will be discounted due to lack of marketability and lack of control.[3] These fractional undivided interest gifts also qualify as gifts of a present interest, so donors without remaining exemption could use this method to transfer real estate over time using discount-leveraged annual exclusion gifts. Importantly, however, an appraisal must be obtained to support the discounted valuation of the fractional interests. An appraisal of these interests will require an appraisal of both the underlying real estate and of the fractional interest, and thus annual exclusion gifting can incur significant appraisal fees.[4]

Even where only TIC interests are gifted and the donor retains an undivided fractional interest in the property, it is still important to be mindful of IRC § 2036 inclusion concerns, though the law here is fairly taxpayer friendly. A donor's post-gift, rent-free use of the property invites an argument for estate inclusion, but if the donor's use is not to the exclusion of the cotenants, case law suggests this would not run afoul § 2036.[5] Moreover, the value of the TIC interest retained by the donor will be included in the donor's taxable estate under § 2033 in any event. Accordingly, so long as the donor's rent-free use

of the property is not disproportionate to his or her retained TIC interest in the property, adverse transfer tax results should be avoided.[6] Donors should clearly delineate these arrangement in a Tenants in Common Agreement, and if a donor's use will be in excess of his or her percentage interest, then a formal lease with fair market rent should be used as described above. In all cases, the property expenses should be allocated pro rata among the cotenants based on their percentage ownership.

Utilizing LLCs

Rather than gifting the real estate itself, a donor might instead consider utilizing a limited liability company ("LLC") or family limited partnership ("FLP"). This will involve forming an LLC, transferring the property to the LLC via real estate deed, and later gifting interests in the LLC rather than in the underlying real estate. The use of an LLC in conjunction with transfers of real estate can provide many benefits.

As an initial matter, even where the client intends to make a one-time gift of 100% of his or her interest in a residence to a single trust, the LLC structure will serve to insulate the other trust assets from liability that may arise from ownership of the property. Where multiple fractional transfers are contemplated, the LLC structure will reduce administrative costs. The gifts can be accomplished with simple assignments of LLC interests, together with periodic amendments to the LLC operating agreement reflecting the changed ownership, rather than via preparation and filing of real estate deeds in the land records. In addition, the LLC agreement can be used to set rules for property management, usage, and transfer of ownership, which will help set the donor's family up for long-term success.

As with the TIC arrangement, if the client wishes to gift less than his or her entire interest in the property at the outset, or gift to more than one beneficiary (or separate trusts for such beneficiaries), using the LLC structure will allow the client to leverage those fractional interest gifts. Specifically, discounts for "lack of control" and "lack of marketability" are achievable under current law for gifts of minority interests in properly structured and respected LLCs. These combined discounts often range from 15%-35%, thus significantly reducing the value of the property for gift tax purposes. As with gifts of fractional undivided interests in the underlying real estate, gifts of LLC interests holding real estate will require contemporaneous real estate and entity-level appraisals to substantiate discounts when the LLC interests are gifted, which can be costly.

It is important to note that the IRS views family LLCs with skepticism and has successfully challenged their use in estate planning transactions on several occasions. In some instances, this has resulted in invalidating the discount claimed for the transfer, and in others it has resulted in estate inclusion under § 2036.[7] To avoid these adverse results, caution is warranted on several fronts. First, as was the case with outright gifts of the entire interest and with TIC gifts, the donor's continued use of the property must be handled appropriately. If the client gifts 100% of the LLC to a trust for descendants or outright to such beneficiaries, then the client should enter a formal lease for full fair market value rent with the entity. If less than all the LLC interests are gifted, a lease agreement for fair market rent should be entered if the donor occupies the underlying real estate for a duration of the year that exceeds his or her percentage ownership. As with TIC ownership, regardless of the donor's use, the LLC members should allocate expenses *pro rata* based on percentage interest.

In addition, when utilizing an LLC, the donor is well advised to clearly respect the separate nature of the LLC and other formalities, and to not retain too much control over the LLC (particularly with respect to distributions and liquidation). Further, it is important that there be legitimate, nontax reasons for the creation of the LLC. In the case of an LLC designed to hold real estate, liability protection and facilitating the family's long-term retention of the property qualify as valid, nontax purposes. However, donors and their advisers must be careful not to undermine these legitimate purposes when structuring the transaction. For example, where the creation and funding of the LLC occurs on the same day as the gifting of the LLC interests, the IRS may make a step transaction argument to ignore otherwise legitimate valuation discounts.[8] Clients should wait a reasonable period

after creation and funding of the LLC before gifting the LLC interests.

As a final point regarding use of LLCs, note that there is a risk the IRS will challenge the use of the annual exclusion when a donor gifts LLC interests in this context.[9] While certain steps can be taken to help ensure gifts of LLC interests will be deemed present interest gifts that qualify for the annual exclusion—such as giving the donee a "put right" for a limited time after the transfer, eliminating restrictions on transfer for a limited time, or by substituting a right of first refusal for the transfer restrictions—these techniques undermine the desired discounts. Because of these challenges, and because incremental annual exclusion gifts of LLC interests will require repeated costly appraisals, it is typically advisable for clients using an LLC to gift real estate to instead make larger, one-time gifts of these interests.[10]

Qualified Personal Residence Trusts

As an alternative to the techniques described above, the donor could instead gift the property to a Qualified Personal Residence Trust ("QPRT"). This type of trust is a creation of statute, and it is an exception to the general rule noted above that a donor cannot gift a successive property interest to family members without triggering adverse transfer tax consequences. The QPRT must meet many technical requirements set forth in the statute in order to qualify for this special treatment.[11]

With a QPRT, the donor transfers his or her residence to the QPRT but reserve the right to occupy the residence for a period of time (the QPRT term). The value of the gift for gift tax purposes is equal to the fair market value of the residence at the time the QPRT is funded, less the actuarial value of the donor's retained term, based on the donor's age and the current IRS § 7520 rate. When QPRT term expires, the residence passes to the donor's family members. If the donor dies before the end of the QPRT term, however, the full value of the residence will be included in the donor's estate.

Assuming the donor survives the QPRT term, title to the residence passes to the beneficiaries and the donor's ownership interest in the property ends. As with other gifts of real estate discussed above, however, the donor can lease the home from the trust for its fair market rent after the QPRT term expires. Notably, in the past the IRS has gone so far as to find that a donor's reserved right to rent the residence for fair market value after the expiration of the QPRT term for the donor's remaining lifetime did not trigger estate inclusion under § 2036.[12]

QPRTs have been somewhat out of favor in recent years due to the historically low interest rates. Specifically, the lower the interest rate, the lower the value of the donor's retained right to use the residence during the QPRT term, and the higher the value of the gift of the remainder interest. As interest rates rise, the QPRT becomes a more attractive wealth transfer strategy.

Conclusion

This article only touches on some of the ways in which donors can approach gifting their personal residences and vacation properties, and the transfer tax provisions that must be navigated in doing so. Despite the challenges that can arise when gifting this type of asset, high net worth clients seeking to use up their lifetime exemption while preserving liquidity may find the benefits outweigh the complexities involved. ⚜

(Endnotes)

1. *Union Planters Nat'l Bank v. United States*, 361 F.2d 662, 666 (6th Cir. 1966).
2. *Id*.; *see also Estate of Gutchess v. Commissioner*, 46 T.C. 554 (1966) ("[T]he spouses' joint occupancy of a home after an interspouse transfer of the residence is insufficient in and of itself to indicate the existence of an agreement for retained enjoyment."); *Stephenson v. United States*, 238 F. Supp. 660, 667 (W.D. Va. 1965) ("[T]he mere fact that the decedent lived in the house after he transferred it to his wife is neither sufficient evidence to infer an agreement nor is it sufficient to satisfy the requirement of retention of possession or enjoyment as set out by Section 2036.").
3. While the IRS has attempted to argue that the valuation discount for TIC interests should be limited to the cost of partition, the courts have consistently rejected this position. *See Estate of Brocato v. Commissioner*, T.C. Memo 1999-424, 78 T.C.M. (CCH) 1243; *Barge v. Commissioner*, T.C. Memo 1997-188, 73 T.C.M. (CCH) 2615; *Estate of Baird v. Comm'r*, 416 F.3d 442 (5th Cir. 2005).

4. This expense can be mitigated by timing the annual gifts in December of Year 1, January of Year 2, December of Year 3, January of Year 4, and so forth, such than an appraisal is needed only every 2 years, assuming the appraiser will not charge for the second appraisal each time.
5. *See, e.g., Wineman Estate v. Commissioner*, T.C. Memo 2000-193, 79 T.C.M. (CCH) 2189; *Estate of Powell v. Commissioner*, T.C. Memo 1992-367, 63 T.C.M. (CCH) 3192.
6. *See* Rev. Rul. 79-109, 1979-1 CB 297.
7. *See Estate of Strangi v. Commissioner*, 85 TCM (CCH) 1331 (2003); *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005); *Estate of Powell v. Commissioner*, 148 T.C. 392; *Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006).
8. *See, e.g., Senda v. Commissioner,* 433 F.3d 1044 (8th Cir. 2006).
9. *See Hackl v. Commissioner*, 335 F.3d 664 (7th Cir. 2003); *Price v. Commissioner*, T.C. Memo 2010, 99 T.C.M. (CCH) 1005; *Fisher v. Commissioner*, 105 AFTR2d 2010-1347 (S.D. Ind. 2010).
10. If a client is without sufficient headroom in their remaining lifetime exemption from estate and gift tax to do this entirely by gift, she could sell the LLC interests to a capitalized grantor trust.
11. *See* IRC § 2702.
12. PLR 200822011.

New Acronym in Town: Virginia Adopts Uniform Fiduciary Income and Principal Act (UFIPA)

by Douglas Murphy

Introduction – Out with the Old, and In with the New

On April 11, 2022, Governor Glenn Youngkin signed into law House Bill 370 which adopts the Uniform Fiduciary Income and Principal Act ("**UFIPA**") into the Virginia Code and repeals the Uniform Principal and Income Act ("**UPIA**"). In doing so, Virginia became the sixth state to adopt the UFIPA, following Utah, Washington, Kansas, Colorado, and Arkansas.

Besides the new acronym, this article provides an overview of the changes that the UFIPA brings. To provide context for these changes, this article examines the history and prior versions of the UPIA, looks at how the UFIPA adapts to the continued modernization of trusts, and concludes with planning recommendations for practitioners.

History: the Uniform Principal and Income Acts

Traditionally, beneficiaries of trusts were typically either entitled to receive: (1) income derived from trust investments; or (2) a subsequent, remainder share of the trust principal. This created an inherent conflict between the interests of the income and remainder beneficiaries. This conflict extended beyond whether the trustee should invest more heavily in income producing assets (benefiting the income beneficiaries) or growth assets (benefiting the remainder beneficiaries) to the manner in which receipts and expenditures are allocated to income or principal.

The Uniform Principal and Income Act (Prior to 1997)

Prior to 1931, the law regarding the allocation of receipts and expenses between the principal and income of a trust had been almost entirely made by court decisions. These holdings were to a large extent harmonious, except that a sharp division had occurred between the courts of Massachusetts and Pennsylvania regarding corporate distributions, such as dividends.[1]

The National Conference of Commissioners on Uniform State Laws ("**Conference**") codified the subject as an attempt to create uniform treatment among the states when allocating receipts and expenses between principal and income. The UPIA was prepared and approved by the Conference in 1931 and updated in 1962 ("**1962 UPIA**") to reflect changes in law and business practices that had taken place.

The 1994 Uniform Prudent Investor Act and the 1997 Revised Uniform Principal and Income Act

In the decades following the 1962 UPIA, there was a major shift in the investment practices of fiduciaries. This shift occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory." The modern portfolio theory posits that any given investment's risk and return characteristics should not be evaluated alone but rather by how it affects the overall portfolio's risk and return.

The Conference responded to this shift to the modern portfolio theory by preparing and approving the Uniform Prudent Investor Act in 1994 ("**Prudent Investor Act**"). The Prudent Investor Act altered the former criteria for prudent investing by providing that the standard of prudence to be applied to any investment should be reviewed as a part of the total

portfolio, rather than to the individual investments themselves.

On the heels of the Prudent Investor Act, came the 1997 UPIA which modified the 1962 UPIA to reflect the adoption of the modern portfolio theory approach by the Prudent Investor Act. The most significant change in the 1997 UPIA was the addition of Section 104, captioned "Trustee's Power to Adjust." This section provides that a trustee may adjust between principal and income to the extent the trustee considers necessary if: (1) the trustee invests and manages trust assets as a prudent investor; (2) the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income; and (3) the trustee determines that the trustee is unable to comply with the requirements of the 1997 UPAI that a trustee administer a trust or estate impartially based on what is fair and reasonable to all of the beneficiaries. The purpose of Section 104 is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income (such as interest, dividends, and rents).

The 2018 Uniform Fiduciary Income and Principal Act – More than just a Change in Name

Similar to the previous updates of the UPIA, the Uniform Law Commission released the UFIPA with the primary purpose to adapt to changes in the design and usage of trusts over the preceding decades. The modernization of trusts in the decades following the 1997 UPIA included: (1) increased use of very long-term trusts; and (2) the increased use of totally discretionary trusts – that is, trusts in which income, as well as principal, is distributable to beneficiaries during the term of the trust not as a matter of right but solely in the discretion of the trustee. Even in trusts with income distributions mandated by requirements of tax law (such as the estate tax marital deduction), the modern trend is for the trustee to have discretion to supplement such income distributions by the invasion of principal.

The UFIPA reflects the modernization of trusts with major updates including: (1) an expansion of the use of the power to adjust between income and principal; (2) the addition of unitrust provisions; and (3) a simplifying change in governing law for purposes of distinguishing income and principal. Each of these updates are discussed below.

1. Trustee's Power to Adjust

As the modern trend moves towards the totally discretionary trust, historical distinctions between income and principal become less important as a technical matter in some cases. Discretionary accumulation of income has the effect of treating income as principal to the extent of the accumulation, and, similarly, the discretionary invasion of principal has the effect of treating principal as income to the extent of the invasion. The UFIPA recognizes that despite the increase in discretionary trusts, the difference between income and principal remains important to impartial trustees and beneficiaries alike.

The UFIPA operates on the premise that the trustee should be able to determine standards for adjusting between income and principal that are reasonable under the circumstances, and to update those standards from time to time. Because of this, the UFIPA retains and expands the trustee's authority to make adjustments between income and principal from year to year (introduced as Section 104 of the 1997 UPIA). This authority is found in new Section 203 of the UFIPA.

New Section 203 (codified as Code of Virginia § 64.2-1038) eliminates the three conditions necessary under the 1997 UPIA's Section 104 for the trustee to adjust between principal and income. Under Section 203, the trustee may adjust between income and principal simply if the trustee determines the exercise of the power to adjust will assist the trustee to administer the trust or estate impartially.

One of the most important ways Section 203 expands the authority to adjust from the 1997 UPIA is by eliminating the precondition that the trust distributions are constricted by the concept of "income" in a way that economic results from year to year could arbitrarily affect. This prevents the odd result where the trustee of a purely discretionary trust has less flexibility to adjust between income and principal than a trustee of a less flexible income trust.

2. Unitrust

Article 3 of the UFIPA (Code of Virginia §§ 64.2-1039 – 1047) adds the authority for a trustee to convert to or from a unitrust or change a unitrust. A "unitrust" is a trust in which the current income beneficiary receives a periodic payment determined with reference to the net value of trust assets, regardless of how much income is produced by the trust assets or the growth of the trust assets. As the value of the trust assets increases, the unitrust amount increases, and vice versa. Thus, there is a unity between the "income" and "principal" beneficiaries because both benefit from an increase in asset values.

There are several potential advantages to the unitrust approach: (1) the "unity" of interest between the current income beneficiaries and successor beneficiaries enable the trustee to invest for long-term growth to benefit all beneficiaries; (2) to the extent that the unitrust approach obviates discretionary invasions of principal, the trustee is protected against challenges by the remainder beneficiaries that any discretionary principal distributions were excessive; and (3) similarly, the unitrust approach eliminates the need to make adjustments between income and principal under Section 203 and thus avoids or minimizes controversy over whether such adjustments are proper.

The 1997 UPIA did not allow for the conversion to unitrust, largely because there was concern about the tax consequences. However, much of the concern was cleared up with the release of final Treasury Regulation § 1.643(b)-1, which provides, in relevant part:

> . . . an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust.

Following the release of this final regulation, Virginia enacted a unitrust statute that followed the 3-to-5-percent safe harbor found in the final regulation. The Virginia statute required the fair market value of the trust be determined at least annually, using such valuation date or averages of valuation dates as deemed appropriate.[2] While Virginia already had a unitrust statute prior to the UFIPA, the new unitrust statute under the UFIPA takes a more expansive approach.

The new Article 3 of the UFIPA does not, with the exception discussed below, limit the unitrust amount to 3-to-5-percent, but provides much broader latitude for the fiduciary to determine the unitrust percentage and also the period used to determine the values. The market value may be determined based on a rolling average of values for periods other than years, such as twelve quarters. Other flexibilities that Article 3 adds include the ability to put a cap on the size of fluctuation on the unitrust amount from period to period and to put a floor and/or ceiling on the unitrust payout amount.

Under UFIPA, trusts that are intended to qualify for a "special tax benefit" are denied much of the expanded flexibility of Article 3, and the unitrust rate is limited to 3-to-5-percent and the period used for calculation is limited to a calendar year. "Special tax benefits" include the annual gift tax exclusion, eligibility of a qualified subchapter S trust (QSST), an estate or gift tax marital deduction, or exemption from generation-skipping transfer tax.

One change that practitioners should be aware of is that the UFIPA changes the waiver language of the repealed unitrust statute.[3] The UFIPA unitrust statute provides the statute is applicable to an income trust, "unless the terms of the trust expressly prohibit use of this article by a specific reference to this article or an explicit expression of intent that net income not be calculated as a unitrust amount."

Given that Virginia had already enacted a unitrust statute, the addition of Article 3 in the UFIPA is less of a major change for Virginia as it is for the UFIPA (compared to the 1997 UPIA). The new Article 3 UFIPA does significantly expand the prior unitrust statute's ability to utilize the unitrust provisions; however, a QTIP or other trust with a "special tax benefit"

will largely remain subject to the prior 3-to-5 percent safe harbor.

3. Governing Law

New Section 104 of the UFIPA, found at Code of Virginia § 64.2-1035, clarifies that the income and principal rules of the state that is the principal place of administration of the trust will be the governing law. This may be superseded by the terms of the trust.

Typically, a "rule of construction" is governed by the law of the place where the trust was created, and a "rule of administration" is governed by the law of the situs of the trust.[4] There is some uncertainty over which category includes an income and principal act, but because income and principal allocations often determine "who gets what" it is likely to be deemed a rule of construction, which would be governed by the law where the trust was created. The UFIPA overrides this result, determining that having such allocations governed by the current place of administration is the most workable approach.

Takeaways for Practitioners

The passage of the UFIPA should not fundamentally shift the drafting or administration of most trusts in Virginia. It does, however, continue to show Virginia's commitment to maintaining statutes consistent with the modernization of trusts. In addition to the UFIPA, Virginia offers many of the features that one would expect in a modern trust jurisdiction, such as: the availability of a directed trust, a domestic asset protection trust statute, and an option to waive the rule against perpetuities for trusts not holding real property.

The UFIPA provides a flexible default statute for the allocation of principal and income which reflects the current structure and usage of trusts. The settlor may override these default provisions in the trust agreement, and the passage of the UFIPA should serve as a reminder for practitioners to review their boiler-plate language and ensure their trust documents reflect the developments in trusts over the preceding decades. Specifically, practitioners should examine and consider provisions relating to the allocation of receipts and expenditures to either income or principal, the ability to convert to unitrust, and the governing law relating to such provisions in relation to the default provisions of the UFIPA. ⚜

(Endnotes)

1. *See Talbot v. Milliken*, 221 Mass. 367, 108 N.E. 1060 (1915) and *Appeal of Smith*, 140 Pa. 344,21 Atl. 438 (1891). The Massachusetts court made the allocation of corporate distributions on the basis of the form of the distribution, under the general theory that dividends payable in stock should go to capital and cash dividends to income. The Pennsylvania court held that the remaindermen are entitled to so much of a distribution as is necessary to preserve the book value of the trust's stock as it was when the trust obtained the stock, with the remainder of the distributions credited to income. The UPIA took the Massachusetts approach.
2. *See* Code of Virginia § 64.2-1003 (repealed).
3. Prior to the UFIPA, the Virginia unitrust statute provided that such section applied to a trust unless "the governing instrument expressly prohibits use of this section by specific reference to this section or expressly reflects the grantor's intent that net income not be calculated as a unitrust amount. A provision in the governing instrument that 'The provisions of § 64.2-1003, Code of Virginia, as amended, or any corresponding provision of future law, shall not be used in the administration of this trust,' or 'My trustee shall not determine the distributions to the income beneficiary as a unitrust amount,' or similar words reflecting such intent shall be sufficient to preclude the use of this section."
4. *See* Restatement (Second) of Conflict of Laws § 268, comment *h* (1971).

Trusts and Estates Section Board of Governors 2022-2023

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NEWSLETTER
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Published by the Virginia State Bar Trusts and Estates Section for its members

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