

# PITFALLS OF THE RICH AND FAMOUS

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## OTHER SCREW-UPS

(a few things to worry about)

- I. Why Do I Need a Trust
  - A. Privacy. A trust unlike a will is not necessarily a public published document, though many beneficiaries have a right to information about the trust and to see a copy of the trust. Virginia Code §55-548.13.
  - B. Avoid Delays. A trust permits immediate use of funds after death or during incapacity without the need to qualify as executor (no wait for a death certificate) or court order.
  - C. Save Money on probate fees. Generally a revocable or irrevocable trust will not be under court supervision and will not incur probate tax nor commissioner of accounts fees for review.
  - D. Life Insurance. Estate tax on life insurance can be avoided by creating and properly maintaining a life insurance trust.
  - E. Avoid Incompetency Hearing. A revocable trust can permit your affairs to be managed while you are not able without the embarrassment and delays of determining if you are competent.
  - F. Trust Pitfalls.
    1. Amendments can be expensive. A trust can be a complex document, when you amend page 3, it may affect pages 9 and 15 as well. Mistakes are easy to make and it takes more time to work with an original and 3-5 amendments, than to work with an amended and restated document.
    2. Joint Trusts. Why?? It permits the illusion of simplicity until the first death, they get to keep everything joint as they have for the last 30 years. If you start to draft one of these, imagine yourself 10-20 years later advising the widow. If it has any tax planning, how will you handle the family trust, marital trust etc etc. What about the widow's right to amend her trust later, how will that play out.

## II. Life Insurance Pitfalls

### A. Bad Beneficiary Selection

1. Trust. A trust may or may not be the proper beneficiary depending on the terms of the trust. Ask the client their goal and then carefully draft/read the documents.
2. Spouse. If the goal is to benefit the entire family, leaving insurance payable to the surviving spouse may waste the decedent's death exemption and may result in assets being dissipated rather than being held to benefit descendants. Is it a second marriage? Are there children by another? Will they really remember what they promised to do when you are gone.
3. Child. If the goal is to benefit the entire family, leaving insurance payable to one or more children may result in assets being dissipated rather than being held to benefit a widow or all the descendants. Will they really remember what they promised to do when you are gone.
4. Company. This could result in the proceeds being subject to income tax or claims of non family members. Sometimes the company should be the beneficiary (key man insurance or insurance to cover corporate obligations), but often more proceeds are paid to the company than intended and result in the other owners benefitting rather than family.

### B. Bad Owner Selection

1. Trust. Usually a trust is a good owner for life insurance, but it could be owned by the wrong type of trust. A revocable trust as owner will result in the proceeds being potentially taxable in the decedent's estate. An irrevocable trust that is improperly drafted or improperly managed may also result in the proceeds being potentially taxable in the decedent's estate or being paid to the wrong parties.
2. Spouse. Usually this is a bad idea. There is little benefit in having a spouse own your policy. It makes it potentially includable in the spouse's estate and may waste the benefit of the insurance. Question why the spouse should own it. Will they really remember what they promised to do when you are gone.
3. Child. This could be the correct owner. If the goal is to benefit the entire family, leaving insurance owned by one or more children may result in assets being dissipated rather than being held to benefit a widow or all the descendants—the owner could change the beneficiary. Will they really remember what they promised to do when you are gone.
4. Company. This could result in the proceeds being subject to income tax or claims of non family members. Sometimes the company should be the

owner, but often more proceeds are paid to the company than intended and result in the other owners benefitting rather than family

C. Lapse

1. Mistake. Forgetting to pay. Missing a payment.
2. Poor Planning. Intentional lapse should be carefully considered. Do you really not need the insurance? Can the insured buy more insurance later if he reconsiders and wants insurance again. Do you really need the premium dollars more than the protection? Should the policy be converted rather than just letting it lapse? Have a medical exam before letting any policy lapse---your family might actually be about to collect. Ask the beneficiaries if they want to pay premiums you do not wish to pay.

D. Taxation

1. Estate Tax. Does a life insurance trust make sense. Should the children own it. What is the client worth if he dies today including insurance. What does it look like the estate tax exemption will be. Has the client already used his estate tax exemption. Do some math.
2. Income Tax. Life insurance proceeds should be income tax free. Carefully review ownership by trusts and entities. Work with a knowledgeable advisor.

E. Divorce. Generally Virginia Code §20-111.1 provides that divorce revokes a beneficiary designation of a former spouse.

1. Separation is not divorce. Revocation occurs upon entry of decree of annulment or divorce.
2. Filing petition is not divorce. Revocation occurs upon entry of decree of annulment or divorce.
3. Expensive reconciliation. Does your sick client want to reconcile rather than follow through on divorce.

F. Review. Remind your client to regularly review their policies. Confirm the policy is in effect through an in-force ledger.

1. Policy Performance. Are scheduled premiums enough to carry the policy to "maturity." Is the return in a lifetime policy matching projections. Compare to what can be obtained via a new policy based on improving actuarial tables.

2. Meeting Needs.

- a. Widow/Widower. What assets and income streams are available to cover surviving spouse needs. Should/Can the surviving spouse go back to work. Can they afford the home. Review need to insure the Homemaker.
- b. Children. Are there minor or disabled children? Check Social Security benefits and available assets to meet needs. Why do you have insurance to benefit adult children?
- c. Taxes. Calculate the current taxable estate under current and projected tax law. Are assets growing? Is there liquidity enough to pay out half of all assets 9 months after death?
- d. Debt. What debt exists? Have you guaranteed debts of others/your business? How will it be paid off with an unexpected untimely death in a recession. Should you buy a term policy to cover the debt. Do you want the mortgage paid off at death?

G. Term vs. Whole Life

1. Cost. Need to calculate estimated cost of insurance over the time the insurance is needed and remember that funds spent on insurance are not available for other needs and wants. Advise your clients to get a second opinion.
2. Protection vs. Investment. Advise your clients to review whether they want to invest through their insurance agent and to compare all investment options. First, review the insurance need. Then talk about whether you want to “invest” in the policy to cover long term insurance needs vs. whether you are investing for retirement etc etc.
3. Needs Assessment
  - a. Amount of Coverage Needed. Current debt, minor children, college funding, dependents.
  - b. Amount of Time Coverage is Needed. Can a term policy cover the debt and obligations you expect over the next 10 to 20 years. Do you just need a little extra coverage until the surviving spouse starts getting your social security.

### III. Employee Benefits Pitfalls

- A. Prenuptial Agreement Failure. There is a mix of authority as to whether a Prenuptial Agreement can waive rights to future retirement benefits under ERISA. Many courts have held that to be effective, the new spouse must sign an ERISA waiver post marriage to waive their rights to your retirement benefits. On the other hand, some courts have found a breach of contract claim for other beneficiaries when a spouse failed to sign post marriage waivers and some have held that the waiver in a prenuptial agreement is enough. You need to plan for the cases that have not yet been decided and take the simple steps---remind your client if they sign a prenupt to have the spouse sign a post marital waiver as soon as they get back from the honeymoon before the 401k becomes huge and the initial bliss is over.
- B. Beneficiary Designation
  - 1. Proper parties. Advise your client to review who is listed as a beneficiary to confirm it is who they want and that a waiver is on file if needed.
  - 2. Update for Life Cycle Changes. Beneficiary designations need to be reviewed upon a marriage or divorce. A waiver may be required after a marriage to continue intended beneficiary other than the new spouse.

### IV. Corporate and Registered Agent Issues

- A. Minute Book.
  - 1. Who needs one? Every entity needs a minute book—even a single member LLC. It need not be fancy, but you need a collection of the critical papers for the LLC, Partnership or Corporation. This becomes very important when something bad happens and the question is asked: who is in charge, who is authorized, etc etc.
  - 2. What should be in it? It should include at a minimum, a copy of the charter, tax id number from the IRS, Bylaws, Operating Agreement, Partnership Agreement, Buy-Sell, Shareholder Agreement etc etc. It should contain annual minutes or consents noting at least once a year what the sole owner or multiple owners have agreed and the authorized management of the entity. It could also include copies of critical leases, loan agreements, insurance policies etc.
- B. Registered Agent. Every entity must have a registered agent. For the attorney, this can be a source of a little income and a lot of responsibility. If you are serving as registered agent, do you know how to reach your client when you get served? Discourage your client from being registered agent. How will she handle it when the sheriff serves her—does your client really want the sheriff showing up to serve papers at the location they have stated as the registered office. What

happens if she dies. Will she maintain a minute book or will you have to recreate it when they get sued or want to borrow from a bank.

C. Officers and Directors.

1. Who is in Charge. Every entity needs to document who can speak for it. Be careful who is named. Think about what happens if the owner of the entity dies. Are there officers in place who can continue to run the company and will be recognized by third parties as having authority to act. If you die without other named officers and directors, think about the steps your executor will have to take to show who owns the company and who can write checks to pay its bills right after your death.
2. Honor vs. Duty. If I list my wife as an officer and things go bad, the IRS may expect her to pay up as a responsible party. Being named an officer is no substitute for salary, many underpaid friends with titles have faced IRS questioning about their personal responsibility for corporate tax obligations they could otherwise have easily avoided by being a mere employee.

D. S. Election. You made an S election, how do you preserve it? Owner limitations need to be checked upon death.

E. Ownership. Who should own it post death---family vs. employees vs. third party sale. How can you be fair to the working child and the non working child.

V. Beneficiary Designation/PODs

A. Poor Man's Will. Beneficiary designations are a poor will substitute but can efficiently move assets to the person named even if that person should no longer receive the proceeds.

B. Rich Man's Equalizer. Some clients favor one child or a special friend by naming them as a beneficiary after executing a plain vanilla equality to family members estate plan. If so, this needs to be reviewed regularly to be carefully coordinated with the written estate plan.

C. Oops

1. Ex \_\_\_\_\_. Your client needs to review all account signature cards from time to time to confirm we do not have any unexpected former spouses or former friends listed as co-owner or beneficiary or signer on the account. This should also occur after Mega Bank acquires your bank to confirm the new Bank's records still reflect your wishes.
2. Shift Estate Tax Burden. For clients with debts or taxable estates, a Beneficiary Designation can reduce net assets to intended heirs. If the estate tax and creditors are paid from the residue of the estate and the

liquid assets are payable at death to special people, the intended remaindermen or beneficiaries designated in the will or trust may get nothing.

3. Joint Ownership – IRS/Creditors. Adding a child as a co-owner for convenience can be expensive. If that child has creditors or develops an IRS problem, your assets may be seized. Your client needs to understand the difference between co-owner, co-signer and POD and select the one that meets their needs. Consider a power of attorney instead.

**Understanding Family Limited Partnerships and  
Limited Liability Companies in Virginia  
as a Tool in Estate Planning and Asset Protection**

**By C. Arthur Robinson, II**

**The author gratefully acknowledges the assistance of L. Cart Rixey in the preparation of this outline**

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## I. **AT FIRST GLANCE: AN OVERVIEW OF FLPs AND FAMILY LLCs**

### A. Overview of the Law Governing Partnerships and LLCs

1. The law governing Partnerships and LLCs are closely related.
  - i. Most LLC statutes borrow heavily from the partnership law and partnership concepts.
  - ii. LLC's also draw conceptually from the corporate statutes.
  - iii. Both types of entities share a number of characteristics which distinguish them from other sorts of entities.
  - iv. Other entities for state law purpose include:
    - a. Corporations of various types under state law
    - b. Various types unincorporated associates including Va. Land Trusts and Va. Business Trusts which share some of the characteristics of Partnerships and LLC's.
  - v. Other entities for tax purposes include a broad array of entities types such as:
    - a. Corporate tax treatment as C or S Corporations
    - b. Disregarded entities from proprietorships to others
    - c. Virginia Business Trusts which can be taxed as either Partnerships or Corporations.
    - d. Special tax treatments for specific types of entities:
      1. Real Estate Investment Trusts (REIT)
      2. Real Estate Mortgage Investment Conduits (REMIC)
      3. Regulated Investment Companies (RIC)—Mutual Funds (special tax treatment)
      4. Public Traded Investment Partnerships
      5. Banking Corporations (special tax treatment)
      6. Mutual Insurance Companies (special tax treatment)
      7. Stock Insurance Companies (special tax treatment)
      8. Various special tax classifications, i.e.:
        - Domestic International Sales Corporations (DISC)
        - Controlled Foreign Corporations (CFC)

- Domestic and Foreign Personal Holding Companies
- Qualified Small Business Corporations
- Consolidated Subsidiaries
- Small Business Investment Corporations
- Personal Service Corporations

9. Non Profit Entities, i.e., Section 501 (c) qualified:

- Corporations
- Trusts
- Unincorporated Associations

10. Trusts of Various Types

11. Religious Organizations

vi. It is important to understand that there are a wide variety of combinations of state law entity types and tax treatments that are currently available.

2. The legal characteristics of Partnerships and LLC make them well suited to certain applications;

i. These entities offer limited liability to some or all of the participants i.e.: partners or members

- a. LLC's provide limited liability to all members
- b. LP's provide limited liability to all limited partners

ii. Under current income tax rules favorable tax treatment is available

- a. LP's under the check the box regulations allow owners to elect tax classification; if no election the default is classification as a partnership with tax treatment under Subchapter K of the Internal Revenue Code. Tres. Reg. §§301.7701-1 to -3. This pass through treatment is highly favorable under many circumstances.
- b. LLC's under check the box are the same as LP's if 2 or more numbers. Single number LLC's are classified as either disregarded entities or can elect to be taxed as corporations.

iii. Under the Va. Statute (and other state statutes) LLC's and LP's enjoy favorable asset protection treatment as detailed in the Outline at III A.

- iv. In Virginia we register any Partnership as a Limited Liability Partnership. Va. Code §§ 50-73.142 to 50-73.143.
3. Reasons for using FLP's and LLC's in the family context:
- i. Ability to transfer capital without the transferee's productivity or initiative being negatively affected.
  - ii. Pooling of assets to reduce costs and diversity.
  - iii. Annual Gifting without loss of control of assets.
  - iv. Keep assets within the family.
  - v. Creditor protection—charging orders and phantom income.
  - vi. Protect assets from family disputes.
  - vii. English rule, i.e. loser pays can be adopted.
  - viii. Divorce protection for family members.
  - ix. Avoid Out of State Probate.
  - x. Beneficial tax structure—conduit treatment.

Note that the characteristics identified in Section 2 make the FLP an attractive vehicle for many families.

4. Both FLP and Family LLC are creatures of statute.
- i. In the case of both types of entity there is a detailed statutory framework in place.
  - ii. For FLP's the Virginia statute is Virginia's version of the Revised Uniform Limited Partnership Act found at Va. Code §§50-73.1 through 50-73.78.
    - a. The present statute was put in place in 1985.
    - b. The statute has been continuously modified since then but the statutory scheme has been very stable since enactment.
  - iii. For LLC's the Virginia statute is the Virginia Limited Liability Company Act found at Va. Code §§13.1-1000 through 13.1-1080.
    - a. The present statute was first enacted in 1991.
    - b. The statute has been continuously modified and there have been major changes which reflect the evolution of LLC's nationwide into the present time.
    - c. LLC's continue to be an area of law which is experiencing rapid change as states continuously borrow ideas from one another.

5. Comparison of entities some basic rules from the statute and tax rules as applicable:



| <b>Type of Entity</b>  | <b>Limited Partnership (LP)</b>  | <b>Limited Liability Company (LLC)</b>  |
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| <b>Definition</b>  | A partnership formed by two or more persons having one or more general partners and one or more limited partners. Va. Code §50-73.1.                       | An entity, having one or more members, that is an unincorporated association without perpetual duration. Va. Code §13.1-1002.   |
| <b>Limits on number of owners</b>                              | General partner, one or more limited partners. Va. Code § 50-73.1.   | May have one or more members. Va. Code § 13.1-1002.   |
| <b>Limits on classes of ownership</b>                          | None; default rule is distribution in proportion to value of contributions but partners may make any financial arrangements they wish. Va. Code §50-73.35. | None; default rule is distribution in proportion to value of contributions but members may make any financial arrangements they wish. Va. Code §§13.1-1022,-1029,-1030. New § 13.1-1022F expressly permits classes of membership.   |
| <b>Restriction on business that may be conducted (non-tax)</b> | An LP may do anything that a General Partnership may do, except as otherwise limited in the partnership agreement. Va. Code § 50-73.9.                     | An LLC may conduct any lawful business except as otherwise limited in the articles of organization. Va. Code § 13.1-1008.   |
| <b>Application of securities law</b>                           | Because limited partners are limited in their ability to participate in the management and control of an LP, their interests may constitute securities.    | Membership interests in professional LLC's sold to individuals intending to practice with the LLC are not securities. Va. Code § 13.1-514(B)(17). Otherwise, same in Virginia as a GP; a facts and circumstances test of the ability of a holder of an interest in a GP to participate in the decisions of the GP is used to determine if it is a security. |

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| <b>Owner's income subject to self-employment tax</b>                                  | Same as LLC.   | Under revised proposed regulations, an LLC member is not subject to employment taxes except on guaranteed payments for services rendered to or on behalf of the LLC unless the member has personal liability for the LLC's obligations, authority to contract on behalf of the LLC or participates in the LLC's trade or business for more than 500 hours during the LLC's taxable year. Prop. Treas. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997). |
| <b>Duration of entity</b>   | The latest date of dissolution must be stated in the certificate of partnership. Va. Code § 50-73.11.  | No date of dissolution needs to be stated in the articles of organization. Va. Code § 13.1-1011.   |
| <b>Tax year</b>   | Same as GP. A GP usually has the same tax year as a majority of its partners or, if the majority of its partners do not have the same tax year, the taxable year of its principal partners, or if the principal partners do not have the same taxable year, the calendar year. I.R.C. §706(b)(1)(B). | Same as GP, unless it has elected corporate tax status. A GP usually has the same tax year as a majority of its partners or, if the majority of its partners do not have the same tax year, the taxable year of its principal partners, or if the principal partners do not have the same taxable year, the calendar year. I.R.C. §706(b)(1)(B).   |
| <b>Filing with State Corporation Commission (SCC) required to establish or create</b> | Yes. Va. Code § 50-73.11.  | Yes. Va. Code §§ 13.1-1004(B),-1010.   |
| <b>Public filings required</b>  | Certificate of limited partnership must be   | Articles of Organization must be filed with the SCC. Va.   |

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|  | filed with SCC. Va. Code §§ 50-73.11,-73.17. File fictitious name certificate in Circuit Court Clerk's Office of city or county where business is to be conducted.   | Code 13.1-1004(B),-1010. Fictitious name certificate is filed in Circuit Court Clerk's Office of city or county where business is to be conducted.  |
| <b>Requirements for having agent for service of process identified and name on file with SCC</b> | Yes. Va. Code § 50-73.4.   | Yes. Va. Code § 13.1-1011(A)(2).  |
| <b>Designation of owners</b>   | General partners and limited partners.   | Members. Va. Code § 13.1-1002.  |
| <b>Persons with authority to bind the entity</b>   | General partners but not limited partners. Va. Code §§ 50-73.24,-73.29.  | Members or managers. Va. Code § 13.1-1021.1. LLC may also designate non-manager officers. §13.1-1022D.  |
| <b>Limits on owner's participation in management</b>   | Only general partners can participate in management; limited partners may not. Va. Code §§ 50-73.24,-73.29.  | Members may participate or may appoint a manager or managers. Va. Code §§ 13.1-1022,-1024.  |
| <b>Permissible contributions by owner in exchange for interest in the entity</b>                 | A general or a limited partner may contribute cash, property, or services, or a promissory note or other obligation to contribute cash, property or services. Va. Code § 50-73.32.   | A member may contribute cash, property, promissory notes, services, or promise to contribute property or perform services in the future. Va. Code § 13.1-1027.  |
| <b>Owner's rights to transact business with the entity</b>                                       | A partner may transact business with the partnership and will have the same rights and obligations as third parties. On winding up, creditors who are partners share equally with all non-partner creditors to the extent permitted by law. Va. Code §§ 50-73.10, 73.52. | Members may transact business with LLC, and subject to applicable law, have the same rights and duties as persons who are not managers or members. On winding up, member and non-member creditors share equally.<br><br>Va. Code §§13.1-1026,-1049. |
| <b>Owner's liability for obligations of the entity</b>   | General partner has full liability; limited partners who do not participate in management are liable only to the extent of their capital contributions. Va. Code   | Members and managers are not liable beyond the extent of their respective capital contributions. Va. Code § 13.1-1019.  |

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|   | §§50-73.24,-73.29.   |  |
| <b>Owner's fiduciary duties</b>                             | General partners have duties similar to those owed by a general partner in a GP. Va. Code § 50-73.29.  | Members of a member-managed LLC and managers have duties of good faith and fair dealing and conduct reasonably believed to be in the best interests of the LLC. Va. Code § 13.1-1024.1.  |
| <b>Liability of the entity for owner's wrongful conduct</b> | Yes. Va. Code § 50-73.95.  | The entity may indemnify members and managers. Va. Code § 13.1-1009(16).   |
| <b>Piercing the corporate (entity) veil</b>                 | A limited partner who participates in the control of the business is liable to persons transacting business with the partnership who reasonably believe that the limited partner is a general partner. Va. Code § 50-73.24.                  | The doctrine of piercing the corporate veil is not expressly applicable to LLC's but similar theories may evolve. Cases in other states almost universally apply corporate standards.  |
| <b>Organizational documents</b>                             | Certificate of limited partnership (required); partnership agreement (not required). Va. Code § 50-73.11.  | Articles of organization (required); operating agreement (not required). Va. Code § 13.1-1002, -1010.  |
| <b>Default management</b>                                   | General partner manages business; limited partners who take an active role in the business are subject to being deemed general partners. Va. Code §§ 50-73.24,-73.29.  | In the absence of an operating agreement, members share in management in proportion to their contributions. Va. Code § 13.1-1022.  |
| <b>Basic ownership unit</b>                                 | Partnership interests. Va. Code § 50-73.44.  | Membership interest. Va. Code § 13.1-1002.   |
| <b>Voting</b>   | Unless the partnership agreement states otherwise, general partners vote the same as in a GP, and all partners, including limited partners, vote on admission of new general partners and assignees, compromise of a partner's obligation to | Unless modified by the articles of organization or operating agreement, each LLC member has one vote, and matters are determined by majority vote, except a unanimous vote is required to amend the operating agreement, admit a new member other than an assignee, and dissolve or merge the LLC. Va. Code § 13.1-1022. |

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|   | <p>contribute, dissolution of the partnership, and continuation after an event of withdrawal.</p> <p>Va. Code §§50-73.27,73.31,-73.33,-73.47-73.49.</p>  | <p>Proxy voting is permitted. § 13.1-1022E.</p>   |
| <b>Allocation of profit and loss</b>  | <p>Pro rata to contributions less returned contributions, unless otherwise stated in partnership agreement. Va. Code § 50-73.34.</p>   | <p>Pro rata to contributions regardless of returned contributions, unless modified in operating agreement. Va. Code §§ 13.1-1029,-1030.</p>   |
| <b>Restrictions on transfer of ownership</b>  | <p>The economic interest of a general or limited partner may be transferred, except as restricted by the limited partnership certificate, the partnership agreement, or applicable securities law. The transferee may only be admitted as a substitute partner according to the partnership agreement or with the consent of the remaining partners. Va. Code §§ 50-73.45,-47.</p>                     | <p>Member's economic interest may be transferred except as restricted by the articles of organization, the operating agreement, or applicable securities law. The assignee may become a member only with the consent of a majority of the other members-managers, not including the assignor, of a manager-managed LLC of which one or more members is a manager or the majority vote of the other members, not including the assignor, of any other LLC.</p> <p>Va. Code §§ 13.1-1039,-1040.</p> |
| <b>Effect of transfer of ownership interest on entity's continuity of life for tax purposes</b> | <p>Same as GP.</p> <p>If 50% or more of the total interest in partnership capital and profits is transferred during a 12-month period, or if no part of the business is continued, the GP will be considered terminated. It will be treated as if its assets were distributed in liquidation and the new and remaining partners contributed the assets to a new partnership.</p> <p>I.R.C. §708(b)</p> | <p>Same as GP.</p> <p>If 50% or more of the total interest in partnership capital and profits is transferred during a 12-month period, or if no part of the business is continued, the GP will be considered terminated. It will be treated as if its assets were distributed in liquidation and the new and remaining partners contributed the assets to a new partnership.</p> <p>I.R.C. §708(b)</p>  |



- B. The Rights, Duties and Responsibilities of partners and Members
1. FLPs have two types of partners, General Partners and Limited Partners.
  2. LLCs have members who may manage the entity or not depending upon the Operating Agreement.
  3. FLPs will generally have a Partnership Agreement which can but is not required to modify the statutory scheme dividing General Partners from Limited Partners.
  4. General Partners in a FLP:
    - i. have all the rights and powers to manage the Partnership; and,
    - ii. are jointly and severally liable for all partnership liabilities; and,
    - iii. owe all partners a duty as a fiduciary of care and loyalty and to provide information to the partners. Va. Code § 50-73.29.
    - iv. General Partners are also able to create liability through their conduct for which the entity will be liable.
  5. Limited Partners in a FLP:
    - i. do not have the right or the power to manage the partnership; and,
    - ii. are liable for all partnership liabilities only to the extent of their capital contributions; and,
    - iii. are not fiduciaries. Va. Code § 50-73.24.
    - iv. a separation between liabilities of the entity and the partner.
  6. LLC will generally have an operating agreement which can designate how the entity is managed and which will regulate the relations of its members. Va. Code § 13.1-1023.
  7. The person with the authority to bind an LLC can be either a member or members or a manager or managers. Va. Code § 13.1-

1021.1. An LLC can also designate non-manager officers with authority to act. Va. Code § 13.1-1022D.

8. Members and managers are not liable beyond the extent of their respective capital contributions to any third parties other than for their individual acts. Va. Code § 13.1-1019.
9. Members of a member managed LLC and managers have duties of good faith and fair dealing and conduct which is reasonably believed to be in the best interests of the LLC. Va. Code § 13.1-1024.1.
10. The Rights, Duties and Responsibilities of Partners and Members are sufficiently different to have a significant impact on the operation of FLPs and LLCs which result in differences in:
  - i. legal rights of non-participant members Limited Partners; and,
  - ii. the value of members and partners interests for tax purposes.

C. Discussion of General and Limited Partnership Interests

1. General Partners have management control of the Limited Partnership.
  - i. Control carries with it fiduciary duties and liability for Partnership level debts.
  - ii. General Partners have complete control no matter how small their ownership interest.
  - iii. Because General Partners have unlimited liability many practitioners recommend the use of a limited liability entity such as a Corporation or an LLC as the General Partner.
  - iv. General Partners can also be individuals where from a planning prospective there is relatively little potential exposure to liabilities i.e. where passive investments are owned by the

Partnership or where activities which generate liabilities are contained within Limited Liability entities.

2. Limited Partnership interests have no management control.
  - i. Limited Partners do not have fiduciary duties or liability for Partnership debts.
  - ii. Limited Partners have no control other than voting rights in very limited circumstances.
  - iii. Voting rights usually pertain to the Partnership itself rather than the conduct of Partnership business.

The typical issues of which Limited Partners can vote are:

- a. Removal of a General Partner,
  - b. Admission of new Partners,
  - c. Changes in the Partnership Agreement,
  - d. Dissolution of the Partnership; and,
  - e. Other votes pertaining to the structure of the Partnership.
- iv. Voting rights do not apply to the management of Partnership assets.
  - v. A Limited Partner who takes on management responsibility can and will lose the limitation of liability which Limited Partners otherwise enjoy.
    - a. This critical fact is both a trap for the unwary and can enable larger discounts.
    - b. Limited Partners in on LP have virtually no control therefore Limited Partnership interests may be susceptible to a larger valuation discount.

3. Limited Liability Company Members can enjoy a status which borrows from both the characteristics of General Partnership interests and Limited Partnership interests
  - i. Members may or may not have management control.
  - ii. Members always enjoy Limited Liability except for their individual acts.
  - iii. Because LLC's have more flexibility in their terms of their potential to control the assets of the LLC arguably the valuation discounts available to LLC interests are lesser.

D. Limited Liability for Partnership Activities

1. Critical distinction needs to be made between Partnership or Limited Liability Company debts and debts of the partners or members.
  - i. Limited Partners and members are not responsible for entity level debts beyond their contribution of capital.
  - ii. General Partners do have responsibility for entity level debts, they have joint and several liability.
2. Partner or Limited Liability Member debts do not affect the Partnership or Limited Liability Company.
3. This separation between owners and the LP or LLC is part of the evolution away from aggregation of its Partners and toward the entity theory which has been a trend in the law for Partnerships and related entities which borrow from partnership law.
4. Limitation of liability i.e. the insulation of individual owners from the debts of the Partnership or Limited Liability Company is a very important characteristic in the asset protection context. The risk from the assets does not reach the Limited Partner or member.

- i. Piercing the Corporate (entity) Veil is the response from the law which allows the limited liability shield to be swept away.
    - ii. Except in the case of General Partners in LP or LLC context however the relatively extreme circumstances required to pierce the veil will usually not be present.
    - iii. While several theories are possible so long as the entity formalities are observed and there is not aggressive conduct courts will usually not reach through the entity to make Limited Partners or Members liable.
  - 5. Individuals always continue to have liability for their individual acts, errors, or omissions.
  - 6. The rule to remember is that Limited Liability is as with most absolutes in the law a general rule which has a number of specific exceptions.
- E. Comparison of Family Limited Partnerships to Trusts and Limited Liability Companies – Choice of Entity and When to use Them
- 1. A comparison of these entities illustrates a number of significant differences which distinguish these entities.
  - 2. The comparison will contrast the differences between traditional trusts and LP's and LLC's.
  - 3. Note that there are as usual hybrid forms which partake of the characteristics of both LP's and LLC's as well as Trusts.
    - i. Note Va. Business Trusts which are governed by statute, Va. Code §§ 13.1-1200 through 1285.
    - ii. Note Va. Land Trusts, Va. Code § 55-17.1.
    - iii. Note also various specialized forms which have developed for relatively narrow applications.
  - 4. A comparison of basic characteristics follows, see chart.





| Type of Entity   | Limited Partnership (LP)   | Limited Liability Company (LLC)   | Trusts   |
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| <b>Definition</b>  | A partnership formed by two or more persons having one or more general partners and one or more limited partners. Va. Code §50-73.1.                       | An entity, having one or more members, that is an unincorporated association without perpetual duration. Va. Code §13.1-1002.   | An entity created either by a Will or Trust Agreement and typically having a Trust Creator (Grantor), a Trustee and one or more beneficial interest holders known as beneficiaries governed by significant Common Law developed over last 600 to 700 years as well as widely scattered statutory authority main statutory authority is found at Va. Code §§ 26-1 to 26-71; 55-1 to 25.1 and 64.1-1 to 206.8. As of October 1, 2012 per Va. Code §26-1 to 26-71 will be recodified as 64.2-1400 to 64.2-1432. Also as of October 1, 2012 §64.1-1 to 216E will be recodified as §64.2-200 to 64.2-620. |
| <b>Limits on number of owners</b>                              | General partner, one or more limited partners. Va. Code § 50-73.1.   | May have one or more members. Va. Code § 13.1-1002.   | No effective limit.  |
| <b>Limits on classes of ownership</b>                          | None; default rule is distribution in proportion to value of contributions but partners may make any financial arrangements they wish. Va. Code §50-73.35. | None; default rule is distribution in proportion to value of contributions but members may make any financial arrangements they wish. Va. Code §§13.1-1022,-1029,-1030. New § 13.1-1022F expressly permits classes of membership. | Beneficiaries may have a wide variety of interests.  |
| <b>Restriction on business that may be conducted (non-tax)</b> | An LP may do anything that a General Partnership may do, except as otherwise limited in the partnership agreement. Va. Code § 50-73.9.                     | An LLC may conduct any lawful business except as otherwise limited in the articles of organization. Va. Code § 13.1-1008.   | None, however significant technical problems which have to be drafted for in order to avoid problems.  |
| <b>Application of</b>  | Because limited partners are   | Membership interests in professional  | N.A. to beneficial interests.  |

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| <b>securities law</b>                                | limited in their ability to participate in the management and control of an LP, their interests may constitute securities. | LLC's sold to individuals intending to practice with the LLC are not securities. Va. Code § 13.1-514(B)(17). Otherwise, same in Virginia as a GP; a facts and circumstances test of the ability of a holder of an interest in a GP to participate in the decisions of the GP is used to determine if it is a security.   |   |
| <b>Owner's income subject to self-employment tax</b> | Same as LLC.   | Under revised proposed regulations, an LLC member is not subject to employment taxes except on guaranteed payments for services rendered to or on behalf of the LLC unless the member has personal liability for the LLC's obligations, authority to contract on behalf of the LLC or participates in the LLC's trade or business for more than 500 hours during the LLC's taxable year. Prop. Treas. Reg. § 1.1402(a)-2(h), 62 Fed. Reg. 1702 (1997). | N.A. beneficiaries are passive recipients.  |
| <b>Duration of entity</b>                            | The latest date of dissolution must be stated in the certificate of partnership.<br>Va. Code § 50-73.11.                   | No date of dissolution needs to be stated in the articles of organization.<br>Va. Code § 13.1-1011.  | Based on Trust instrument or Will. Subject in most states to some version of the Rule Against Perpetuities. Rule has been codified in most states and numerous exceptions and complexities exist. |
| <b>Tax year</b>                                      | Same as GP. A GP usually has the same tax year as a majority of its partners or, if the majority of its                    | Same as GP, unless it has elected corporate tax status. A GP usually has the same tax year as a majority   | Dependent on how trust created, but usually required to convert to calendar year within statutorily mandated time frame.  |

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|  | partners do not have the same tax year, the taxable year of its principal partners, or if the principal partners do not have the same taxable year, the calendar year. I.R.C. §706(b)(1)(B).                  | of its partners or, if the majority of its partners do not have the same tax year, the taxable year of its principal partners, or if the principal partners do not have the same taxable year, the calendar year. I.R.C. §706(b)(1)(B). |   |
| <b>Filing with State Corporation Commission (SCC) required to establish or create</b>            | Yes. Va. Code § 50-73.11.   | Yes. Va. Code §§ 13.1-1004(B),-1010.  | No  |
| <b>Public filings required</b>   | Certificate of limited partnership must be filed with SCC. Va. Code §§ 50-73.11,-73.17. File fictitious name certificate in Circuit Court Clerk's Office of city or county where business is to be conducted. | Articles of Organization must be filed with the SCC. Va. Code 13.1-1004(B),-1010. Fictitious name certificate is filed in Circuit Court Clerk's Office of city or county where business is to be conducted.                             | No, but may be subject to significant reporting requirements to court or beneficiaries. |
| <b>Requirements for having agent for service of process identified and name on file with SCC</b> | Yes. Va. Code § 50-73.4.  | Yes. Va. Code § 13.1-1011(A)(2).  | None, Trustees acts and is the proper party for service of process.                     |
| <b>Designation of owners</b>   | General partners and limited partners.  | Members. Va. Code § 13.1-1002.  | Trustee holds bare legal title for the benefit of Beneficiaries.                        |
| <b>Persons with authority to bind the entity</b>   | General partners but not limited partners. Va. Code §§ 50-73.24,-73.29.   | Members or managers. Va. Code § 13.1-1021.1. LLC may also designate non-manager officers.   | Trustee(s)  |

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|  |  | §13.1-1022D.   |  |
| <b>Limits on owner's participation in management</b>                             | Only general partners can participate in management; limited partners may not. Va. Code §§ 50-73.24,-73.29.  | Members may participate or may appoint a manager or managers. Va. Code §§ 13.1-1022,-1024.   | Trustee has complete management authority subject to fiduciary duty. Beneficiaries have no authority.  |
| <b>Permissible contributions by owner in exchange for interest in the entity</b> | A general or a limited partner may contribute cash, property, or services, or a promissory note or other obligation to contribute cash, property or services. Va. Code § 50-73.32.   | A member may contribute cash, property, promissory notes, services, or promise to contribute property or perform services in the future. Va. Code § 13.1-1027.   | While possible usually contributions may be Trust Grantors.  |
| <b>Owner's rights to transact business with the entity</b>                       | A partner may transact business with the partnership and will have the same rights and obligations as third parties. On winding up, creditors who are partners share equally with all non-partner creditors to the extent permitted by law. Va. Code §§ 50-73.10, 73.52. | Members may transact business with LLC, and subject to applicable law, have the same rights and duties as persons who are not managers or members. On winding up, member and non-member creditors share equally. Va. Code §§13.1-1026,-1049. | Beneficiaries have no rights to transact business.   |
| <b>Owner's liability for obligations of the entity</b>                           | General partner has full liability; limited partners who do not participate in management are liable only to the extent of their capital contributions. Va. Code §§50-73.24,-73.29.  | Members and managers are not liable beyond the extent of their respective capital contributions. Va. Code § 13.1-1019.   | Property is subject to debts of beneficiaries unless exception applies. Creators who are also beneficiaries have protection or self settled Trusts, Va. Code § 55-545.03:2 |
| <b>Owner's fiduciary duties</b>  | General partners have duties similar to those owed by a general partner in a GP. Va. Code § 50-73.29.  | Members of a member-managed LLC and managers have duties of good faith and fair dealing and conduct reasonably believed to be in the best interests of the LLC. Va.  | Trustee subject to fiduciary duties as defined in Statute and Common Law. Beneficiaries have no such duties.   |

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|   |   | Code § 13.1-1024.1.   |   |
| <b>Liability of the entity for owner's wrongful conduct</b> | Yes. Va. Code § 50-73.95.   | The entity may indemnify members and managers. Va. Code § 13.1-1009(16).  | Trust is not liable for Trustee's wrongful conduct, beneficiaries may be able to recover from Trustees for acts related to Trust. Absent spendthrift provisions Trust liable for beneficiary debts. |
| <b>Piercing the corporate (entity) veil</b>                 | A limited partner who participates in the control of the business is liable to persons transacting business with the partnership who reasonably believe that the limited partner is a general partner. Va. Code § 50-73.24. | The doctrine of piercing the corporate veil is not expressly applicable to LLC's but similar theories may evolve. Cases in other states almost universally apply corporate standards.                         | N.A.  |
| <b>Organizational documents</b>                             | Certificate of limited partnership (required); partnership agreement (not required). Va. Code § 50-73.11.   | Articles of organization (required); operating agreement (not required). Va. Code § 13.1-1002, -1010.   | Trust Agreement or Will.  |
| <b>Default management</b>                                   | General partner manages business; limited partners who take an active role in the business are subject to being deemed general partners. Va. Code §§ 50-73.24,-73.29.   | In the absence of an operating agreement, members share in management in proportion to their contributions. Va. Code § 13.1-1022.   | Trustee always manages property.  |
| <b>Basic ownership unit</b>                                 | Partnership interests. Va. Code § 50-73.44.   | Membership interest. Va. Code § 13.1-1002.  | Beneficial interest in Beneficiary.   |
| <b>Voting</b>   | Unless the partnership agreement states otherwise, general partners vote the same as in a GP, and all partners, including limited partners, vote on admission of new general partners and assignees,                        | Unless modified by the articles of organization or operating agreement, each LLC member has one vote, and matters are determined by majority vote, except a unanimous vote is required to amend the operating | N.A.  |

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|   | <p>compromise of a partner's obligation to contribute, dissolution of the partnership, and continuation after an event of withdrawal.</p> <p>Va. Code §§50-73.27,73.31,-73.33,-73.47,-47.49.</p>   | <p>agreement, admit a new member other than an assignee, and dissolve or merge the LLC. Va. Code § 13.1-1022. Proxy voting is permitted. § 13.1-1022E.</p>   |   |
| <b>Allocation of profit and loss</b>  | <p>Pro rata to contributions less returned contributions, unless otherwise stated in partnership agreement. Va. Code § 50-73.34.</p>   | <p>Pro rata to contributions regardless of returned contributions, unless modified in operating agreement. Va. Code §§ 13.1-1029,-1030.</p>  | <p>Per creating instrument.</p>   |
| <b>Restrictions on transfer of ownership</b>  | <p>The economic interest of a general or limited partner may be transferred, except as restricted by the limited partnership certificate, the partnership agreement, or applicable securities law. The transferee may only be admitted as a substitute partner according to the partnership agreement or with the consent of the remaining partners. Va. Code §§ 50-73.45,-47.</p> | <p>Member's economic interest may be transferred except as restricted by the articles of organization, the operating agreement, or applicable securities law. The assignee may become a member only with the consent of a majority of the other members-managers, not including the assignor, of a manager-managed LLC of which one or more members is a manager or the majority vote of the other members, not including the assignor, of any other LLC. Va. Code §§ 13.1-1039,-1040.</p> | <p>Generally interests are not transferable but absent spendthrift provision beneficiaries can alienate their interests to creditors.</p> |
| <b>Effect of transfer of ownership interest on entity's continuity of life for tax purposes</b> | <p>Same as GP.</p> <p>If 50% or more of the total interest in partnership capital and profits is transferred during a 12-month period, or if no part of the business</p>   | <p>Same as GP.</p> <p>If 50% or more of the total interest in partnership capital and profits is transferred during a 12-month period, or if no part of the business</p>   | <p>Transfer of interest does not affect life of Trust. Duration governed by Trust instrument.</p>   |

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|  | <p>is continued, the GP will be considered terminated. It will be treated as if its assets were distributed in liquidation and the new and remaining partners contributed the assets to a new partnership.<br/>I.R.C. §708(b)</p> | <p>is continued, the GP will be considered terminated. It will be treated as if its assets were distributed in liquidation and the new and remaining partners contributed the assets to a new partnership.<br/>I.R.C. §708(b)</p> |  |
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5. The characteristics which make LP's and LLC's favorable vehicles for family asset protection and estate tax or income tax planning are generally either absent in Trusts or less favorable
  - i. Trusts usually do not limit liability for all parties involved.
  - ii. Trusts do not facilitate discounts for lack of marketability and fractional (minority) interests.
  - iii. Tax treatment for Trusts is much different.
    - a. Always the possibility of tax at the Trust level.
    - b. Conduct like treatment with major and important differences between treatment (Subchapter J. v. Subchapter K. Treatment)
  - iv. Governance of the entity is entirely different.
  - v. Structure by its nature is less flexible.
6. Choosing between LP's and LLC's is much harder.
  - i. Factors to evaluate include: importance of Limited Liability for all interests,
  - ii. Amount of control which needs to be put into the hands of various parties,
  - iii. Whether an entity will be used as General Partner or Manager,
  - iv. Importance of as much discount as possible,
  - v. Extent to which state law is settled as to LLC's, since they are relatively new entities; and,
  - vi. Importance of the flexibility to designate non-members as managers.

F. Current Case Law and Legislative Developments

1. In the recent sessions of the Virginia General Assembly, Limited Liability Companies and Limited Partnerships were the subject of a number of legislative changes.

- i. A variety of legislative changes affecting either Limited Liability Companies or Limited Partnerships were part of the recent legislative sessions.
  - ii. By and large these changes added cross referencing material to the Code, and made relatively little if any substantive changes. However, in the case of two items of legislation there are significant and pervasive changes which should be detailed here.
2. Changes relative to limited liability entities including LLP's and LLC's.
- i. the LLC changes are as follows:
    - a. §13.1-1052 which deals with registration of foreign limited liability companies substantially amended the procedure by which a foreign limited liability company registers to do business in the Commonwealth of Virginia.
    - b. §13.1-1060 merger of foreign limited liability company registered to transact business in the Commonwealth modified the requirements for notification of the commonwealth in the case of merger of a foreign limited liability company.
    - c. New Code § 13.1-1060.1 added a new section which deals with entity conversion of foreign limited liability companies registered to transact business in Virginia.
      - 1. This new Code section provides for filing with the commission appropriate notification with respect to all aspects of the merger including the surviving entity.
      - 2. The Code section provides that if the statutory frame work is adhered to all property owned by the foreign limited

liability company in the Commonwealth shall pass to the surviving or resulting entity.

- d. § 13.1-1064 dealing with failure to timely pay annual registration fees was modified to include the necessary changes with respect to mergers of foreign limited liability companies.
- e. §13.1-1004 was amended to provide that the commission has the power to act on a petition filed by an LLC at any time to correct commission records, to eliminate clerical errors, and filings made by persons without authority to act of the LLC.
- f. §13.1-1005 was amended to provide for \$25 application fee for Certificate of Cancellation of a foreign LLC.
- g. §13.1-1018.1 was amended to provide that an LLC can change its principle office by filing with the Commission a statement including the LLC name, the address of its current office and the address of its new office.
- h. §13.1-1023 was amended to provide that an LLC is bound by its operating agreement whether or not the LLC executes the operating agreement.
- i. §13.1-1035 this sections concerns making distributions and this section does not apply to liquidation distributions under Article 9.
- j. §13.1-1036 states that a member who gets distributions in violation of the Articles or in violation of the operating agreement is liable to the LLC for two years (this time period was previously six years).

- k. §13.1-1042 provides that a derivative proceeding cannot be commenced until written demand is made on the LLC to take action and 90 days of expire from the date of delivery of that demand unless the members notified prior to 90 days that the demand was rejected or that irreparable injury to the LLC will result by waiting those 90 days. This section also provides that an LLC commences a review of allegations contained if in the demand then the court may stay derivative proceedings.
- l. §13.1-1047.1 is a newly enacted section which provides that after dissolution of an LLC and before winding up of the LLC is completed all of the members may waive the right to have the LLC business wound up in the existence cancelled. In this case the LLC carries on as if the dissolution had not occurred.
- m. §13.1-1050.2 states if an LLC does not pay its annual registration fee before the last day of the third month after the due date the LLC is automatically cancelled.
- n. §13.1-1050.3 was amended to provide that the LLC will be involuntary cancelled if convicted of 8 U.S.C. §1324a(f) which concerns the unauthorized employment of aliens. The LLC must immediately report this conviction to the commission and LLC will not be eligible for reinstatement for one year. Similarly §13.1-1056.2 was amended to provide that the same applies for foreign LLCs convicted under that same statute.



is cancelled pursuant to the section, its property and affairs shall automatically pass to its General Partners as Trustees and liquidation, and the Trustee shall then proceed to collect that assets of the Partnership, sell, convey, and dispose of such of its properties as are not to be distributed in kind to its partners, pay, satisfy and discharge its liabilities and obligations and do all other acts required to liquidate its business and affairs.

- g. §50-73.2 amended the requirement of an LP name.
  - h. §50-73.5 changed the requirement for a registered agent to sign documents of the LP.
  - i. §50-73.15 was amended to provide that it was illegal to sign any document that you know is false to be sent to be sent to the Commission and that such activity is classified as a Class I misdemeanor.
  - j. §50-73.52:6 was amended to provide that Limited Partnerships convicted of 8 U.S.C.§13.24a(f) which covers the unauthorized implement of aliens must immediately report the conviction to the Commission and they will not be eligible for reinstatement for one year. Similarly §50-73.58:2 states that the same applies to foreign limited partnerships convicted under that same criminal statute.
  - k. §50-73.58 provides that the requirements for applying to cancel a certificate of registration for foreign limited partnerships.
3. Changes for limited liability companies and to a certain extent family limited partnerships.
- i. In Section 13.1-1019 a limited liability company may now delegate the powers of a member or manager under the statutory provisions of

13.1-1022 or 13.1-1024 and such delegated powers to an individual shall, for the purpose of this section, make an individual to whom power is delegated an agent of the limited liability company.

- ii. Section 13.1-1022, deals explicitly with the designation of officers who shall not be deemed managers of the limited liability company, this section of the Virginia Code has also been amended to provide greater flexibility in defining the relative rights, powers and duties of different classes of members, different rights as managers and differentiates officers who are elected as limited liability company officers from any others.
  - iii. A parallel change was made in Section 13.1-1024, with respect to management of the limited liability company, and makes it clear that officers will not automatically be deemed to be managers of the limited liability company unless the articles of organization or operating agreement so provide.
4. These legislative changes are not extremely significant from an asset protection standpoint. In a number of circumstances they assist in confirming the limited liability nature of limited liability company interest.
5. The case, The Dunbar Group, LLC et al. v. Archie F. Tignor, et al., 267 Va. 361(2004), is significant from the standpoint of LLC law in that it provides guidance with respect to the circumstances under which pursuant to:
- i. § 13.1-1040.1 of the Code of Virginia a court ordered expulsion of a member may take place and the consequences of such disassociation of a member from the limited liability company.
  - ii. § 13.1-1040.1 in relevant part provides that a member may be disassociated from a limited liability company upon the occurrence of any of the following events:
    - a. “On the application by a limited liability company or other member, the members expulsion by the judicial

determination because the member engaged in wrongful conduct that adversely and materially affected the business of the limited liability company.”

b. “The member willfully or persistently committed a material breach of the Articles of Organization or Operating Agreement, or”

c. “The member engaged in conduct relating to the business of a limited liability company which makes it not reasonably practicable to carry on the business with the member.”

6. In the above cited case the court dissociated a member from a the Limited Liability Company based upon the facts and evidence. In a separate application, Tignor filed an Application for Judicial Dissolution on the grounds cited in Code § 13.1-1047 that it was “not reasonably practical to carry on the business of the LLC in conformity with the Articles of Organization and the Operating Agreement.”

i. The case stands for the proposition that where the evidence is insufficient to support the dissolution of the limited liability company, the court will not order the dissolution of such a company. The court found that in this case the remaining member was reasonably able to continue the business of the limited liability company and therefore a judicial dissolution would not be ordered.

ii. The case stands for the proposition that it is possible to expel a member of a limited liability company through the dissociation process provided in Virginia statute, and allow the remaining member or members to effectively control the business of the limited liability company as long as it is practical to do so. In such a situation a limited liability company could continue its business with one member being disassociated and therefore having no voice in the affairs of the

- limited liability company for any purpose as provided by the statute other than on dissolution and distribution.
- iii. The case bolsters the theory of limited liability companies as separate entities and so is significant in that regard.
7. The case of Gowin v. Granite Depot, LLC, et al., 272 Va. 246(2006) is significant for two principles:
    - i. Waiver by a manager of payment on a promissory note did not bind the company;
    - ii. Termination of the defaulting member, who defaulted on a promissory note to the LLC which was the consideration to purchase his interest after an amendment of the Articles of Organization to permit such termination did not breach any fiduciary duty; and
    - iii. The case is important because it recognizes the entities' ability to enforce obligation, irrespective of the acts of separate individuals and it articulates a limit on the fiduciary duty owed by members to one another.
  8. The case of 1924 Leonard Road, L.L.C. v. Dorothy Van Roekel, et al., 272 Va. 543(2006) is significant only for its strong recognition that an LLC is separate and distinct entity and therefore distinguishable from its members, managers, and others. The case was decided on the issue of a property dispute in which certain individuals claimed an interest.
  9. A Florida case Shaun Olmstead v. Federal Trade Commission 44 So.2d 76(2010) has significantly clarified the analysis with respect to charging orders.
    - i. Charging orders are the only means available to a creditor to seek compensation from the source of Partnership or multiple owner LLC assets.
    - ii. The questions has arisen as to whether a single member is likewise protected and whether the only mechanism for recovery is a charging order to reach entity level assets.

- iii. The Eleventh Circuit, in F.T.C. v. People's Credit First, LLC, 621F.3d 1327 (11Cir.2010), after reviewing the Olmstead decision concluded that in the case of single member LLC's "the courts were permitted to order a judgment debtor to surrender all right, title, and interest in the debtor's single member LLC to satisfy an existing judgment."
10. The case of Siska Trust v. Milestone Development, 282VA. 169(2011) Virginia Supreme Court determined that if an LLC is the subject of a derivative action the LLC must be a party to the suit. This applies even if all members of the LLC are either plaintiffs or defendants in the suit.

## II. FAMILY LIMITED PARTNERSHIP IN ESTATE PLANNING

### A. Funding Family Limited Partnerships and Family LLC's

#### 1. Tax Treatment

- i. The tax treatment for funding of limited partnerships and limited liability companies is similar based upon the classification of these entities for tax purposes.
- ii. Both entities are typically treated as partnerships for federal income tax purposes. Because this is the case a partner is generally not taxed on the receipt of an interest in the entity in exchange for a contribution of property unless the liabilities on the contributed property exceed the partners basis in the property. Internal Revenue Code Sections 721,752(b), Treasury Regulation §1.752-1c.
- iii. The tax treatment is such that typically the entity can be created tax free. It is important however to remember that there are significant traps for the unwary with respect to the creation of partnership interest. Initially it should be confirmed that assets with debt in excess of basis, which would trigger deemed gain under Section 752 of the Internal Revenue Code are not being contributed to the partnership, or if they are the deemed gain is planned for as part of the partnership creation.
- iv. It is also important in order to avoid I.R.C. Section 704(b) and 704(c), Deemed Sale Rules, that partners contribute property and get back in proportion their interest without changing the character of the underlying investment.
- v. This is best explained by an example, assume that Partner A owns appreciated real estate with the basis of \$100,000 fair market value of a Million and debt of \$500,000. Assume Partner B owns \$500,000 in cash, and that Partner A and Partner B will each contribute to these respective property interest to the partnership taking back a 50% interest. This example represents an example in which deemed gain

- vi. From a tax perspective then it is clear that in order to avoid potential gain on the formation of these entities, there are several steps which we need to take. First we need to examine carefully the property which is to be contributed by our clients, and whenever debt is present with respect to business property or real estate the basis should be carefully checked to avoid the unintended income tax consequences of deemed gain on contribution to the partnership. In addition, care should be taken to make sure that the partners are contributing similar property to the partnership, thus in the case of A and B who are husband and wife we would first transfer a 50% interest in the appreciated real property to Partner B, and a 50% interest in the cash to Partner A, and then Partners A and B whom presumably are husband and wife would contribute to the Family Limited Partnership their respective interests in each of the properties. This would avoid the deemed gain rules of Section 704(b) and (c) and assuming debt is not present in excess of basis would also avoid the deemed gain rules of Section 752 of the Internal Revenue Code.

- vii. It is important to note that in the context of a Family Limited Partnership, specifically where we have a husband and wife of our older generation as the planned general partners and creators of the entity we have a unique opportunity to restructure the property coming into the partnership using gifts between husband and wife which qualify for the unlimited marital deduction for transfers during lifetime between spouses.
- viii. Finally, it is important from a tax perspective that the husband and wife of the senior generation create the Family Limited Partnership and contribute property taking back 100% of the partnership interests. It is important for purposes of avoiding the gift on formation argument about which will be covered in Sections II, II B. and III B. of this outline.

2. Mechanics in the case of a Family Limited Partnership

- i. Under the Virginia Limited Partnership Act, ownership interests in the Family Limited Partnership are reflected in the Partnership Agreement. Therefore, mechanically the Partnership Agreement on creation will typically reflect the senior generation as initial general partners with some percentage ownership which should be carefully selected to avoid loss of control by vote of the limited partners as well as certain limited partners.
- ii. Most typically, the initial limited partners would be the respective trusts created for the husband and wife. Mechanically thereafter transfers of partnership interests are best affected by an appropriate amendment to the Partnership Agreement which reflects the transfer of percentage interest and also deals with the issue of allowing the transferees to rise from assignee status which is the statutory default to transferees of interest in a limited partnership to the status of limited partners. The mechanics in the case of a Family Limited Partnership are therefore relatively simple.

3. Mechanics in the case of a Limited Liability Company
  - i. The mechanics in the case of a limited liability company of contributing property to the limited liability company in exchange for the interest entail the same tax considerations.
  - ii. In the case of the LLC however, the Operating Agreement is the relevant document in which the interest of all of the members of the limited liability company will be reflected. In the case of the limited liability company it is important that the Operating Agreement specify who has management control of the limited liability company because absent specifics in the Operating Agreement all members would have management authority.
  - iii. In the context of a Family LLC we typically restrict management authority to the husband and wife who are the creators of the limited liability company even if their trusts or others will either initially or subsequently become members of the limited liability company. In the creation of the limited liability company interest it is important to define both management rights and ownership interest because there is no statutorily required differentiation as is the case with the family limited partnership between general partners who have management authority and limited partners who do not.
  - iv. In the case of a limited liability company, because the limited liability company statute borrows from the corporate statute as well as partnership statutes, in addition to the schedule of ownership imbedded in the Operating Agreement, the statute provides for certificates of interest which can be created to reflect ownership in the limited liability company. Such certificates of interest can thereafter be transferred analogous to a transfer of stock certificates in a corporation.
  - v. A trap for the unwary exists however, in that in addition to the transfer of certificates of interest an appropriate amendment to the operating

agreement which both defines ownership interest and management rights will need to be made in the subsequent transfer of LLC interest. The amendment to the operating agreement also has the effect of raising a transferee from the default status of assignee which is the status of a transferee assigned by the statute, to the level of member with such management rights as may be defined in the Agreement.

4. In the case of both the limited partnership and the LLC a condition predicate to the contribution of property by the Limited Partners is the correct formation of the entity under that statute by filing either Articles of Partnership in the case of limited partnership or by filing Articles of Organization in the case of the LLC.
5. Practice Pointer
  - i. It is critically important that both the income tax and state law perspective as well as all the requisites of state law be carefully considered and strictly adhered to in the contribution of the interest in order to avoid unintended gift tax, income tax, or state law consequences.

B. Gifting of Family Partnership and LLC Interests

1. Timing of the Gift
  - i. It is important in order to achieve optimal results both under state law and under federal gift tax principals that the timing of gifts be carefully considered. In the formation discussion in II A. above the paradigm discussed was a contribution by husband and wife who are the founders of the family limited partnership by contributing various items of property and taking back 100% of the family limited partnership or family LLC interests.
  - ii. This basic transactional structure is both deliberate and represents a best practice because it avoids the potential problem with gifting of

interest that are present both on state law grounds and on federal estate and gift tax principals.

2. State Law Concerns:

- i. From the state law perspective it is important to remember that the contribution of property to a partnership is done in exchange for partnership interest and likewise with the LLC the contribution of property is done in exchange for the LLC membership interest. This is important because Virginia, as do most states, creates significant points of attack for creditors where property is transferred without an exchange for full consideration. The relevant statutes are the voluntary conveyance and fraudulent conveyance statutes in Virginia, which may be found in the Virginia Code of 1950, as amended §§ 55-80 through 55-105.
- ii. In order for either the voluntary or fraudulent conveyance statutes to attach, there typically must be either a transfer without consideration or a transfer with the intent to defraud creditors, which typically would entail property leaving the dominion and control of the transferor without something being received in exchange which constitutes full consideration for the property.
- iii. A transfer of property in exchange for 100% of the partnership interest by a husband and wife arguably does not trigger either of these statutes because the creator of the limited partnership or limited liability company is transferring property to the entity and is receiving in exchange the consideration of 100% of the entity interest. Thus the creator of a limited partnership or limited liability company has logically transformed the property without conveying it to another without consideration and without conveying it with an intent to defraud creditors. At the end of the transaction the creator of the limited partnership interest or limited liability company membership interest owns 100% of the property which they previously owned.

3. The tax considerations with respect to potential gifts of interest and the timing of the transaction are similar from a tax perspective.
  - i. The creation of the limited partnership or limited liability company which transforms the property in the hands of the creator from real estate, business interests, marketable securities cash or whatever other property into limited partnership interest is a logical transformation under state law which federal income and estate taxes may not ignore.
  - ii. To the extent that such a transformation works to provide a different value for partnership interests as discussed in Section C and D of this outline, and B and C of Section III of this outline, the logical transformation should be completed before any transfers of interest take place in order to avoid one potential argument which has been raised by the Internal Revenue Service which is denominated as the indirect gift argument. See Section III B & C below.
  - iii. It is clear based on this analysis that the timing of gifts is subsequent to formation. Thereafter, fractional interests are typically transferred in the case of family partnership and family LLC interest to downstream beneficiaries such as children or grandchildren or perhaps other beneficiaries.
  - iv. Mechanically the transfers are accomplished by an appropriate Amendment of Partnership Agreement or LLC Agreement, and in the case of the LLC the issuance of certificates of interest which represent the gifted portions. From the perspective of the transferors gifts of such interest represents gifts which are potentially taxable under the Federal Gift Tax and which properly designed will qualify to the extent of its availability for the annual exclusion of \$13,000.00 per year.
  - v. The annual exclusion of \$13,000.00 on the part of each donor is per donee and can offset a portion of the interest gifted. In fact, for many clients the amount of partnership gifts will be carefully designed to fit

within the annual exclusion available for gifting of interest so that no portion of the lifetime gift tax credit or the estate tax creditor utilized in making the transfers.

- vi. Gifts may also be made of limited partnership interests or limited liability company interest which exceed the annual exclusion for gift tax purposes. This would typically be done in the case of partnerships which own property or LLC's which own property which is expected to appreciate substantially and represents an opportunity to trap the appreciation with respect to that property outside of the estate of the creator of the limited partnership or limited liability company. Larger gifts by their nature will typically exceed the annual exclusion amount, and therefore will utilize some portion of a lifetime gift exclusion with the creators of partnership or limited liability company.
- vii. The gifts also represent gifts of a percentage interest in the partnership itself, with that percentage typically being a relatively small percentage of the overall ownership of the partnership. As a result, gifts of partnership interest or LLC interest are eligible for two types of potential discounts which can be broadly grouped as minority interest discounts which will be covered in Section II C. of the outline, and lack of marketability discounts which will be covered in Section II D. of the outline.
- viii. These discounts allow the use of a family limited partnership or family LLC to leverage the amount of property transferred based on the discounts for a given utilization of either annual exclusion or lifetime gift exclusion in such a way that absent the discount more than \$13,000.00 per year per donee or greater than the lifetime exclusion amount in property can conceivably be transferred without triggering either the utilization of the life time credit or if such credit is utilized any tax on the property transferred being required to be paid in cash.

### C. Minority Interest Discounts

1. Minority Interest Discounts constitute one of two broad categories of potential discounts which are available in the context of Family Limited Partnerships and Family Limited Liability Companies.
2. The other potential set of discounts, which are generally categorized as Lack of Marketability Discounts, are valuation discounts that apply because of the entity structure and will be discussed in Section II D of this outline.
3. The basic concept with respect to Minority Interest Discounts reflects the fact that in the context of these entities where properly drawn, downstream family members who are gifted interest will typically receive a small, fractional share in the form of either a Limited Partnership interest or a Limited Liability Company membership interest, which carries with it little or no rights to management.
  - i. This is so because, in the case of the Limited Partnership, the inherent nature of a Limited Partnership, which carries with it no management rights with regard to the underlying assets.
  - ii. In addition, because of the relatively small, fractional interest involved, the Minority Interest Discount represents a discount which is key to the lack of voting control of the entity.
  - iii. Consider the following example: Of two assets, which would be considered to have the greater value?
    - a. A certificate of deposit in the amount of \$10,000, or
    - b. A 1% interest in an entity which represents \$10,000 in underlying value but over which
      1. the interest holder has no management control of the type of investment made; and
      2. No ability at the level of the entity to either manage and control the investment or

3. to determine if and when distributions of income from the investment might be made.
- iv. A logical answer with respect to the question of which interest is less valuable is relatively easy to see.
    - a. Clearly, the \$10,000 1% interest is substantially less valuable than the \$10,000 CD to the interest holder, because,
    - b. the \$10,000 CD represents an asset over which the owner has complete dominion and control, which can be liquidated and utilized in whatever fashion the interest holder chooses.
  - v. As a consequence, notwithstanding the protestations of the Internal Revenue Service, Minority Interest Discounts have consistently been allowed over time.
    - a. See generally and by way of example: Propstra v. US, 680 F.2d 1248 (9<sup>th</sup> Circuit 1982); Estate of Bright v. US, 658 F.2d 999 (5<sup>th</sup> Circuit 1981); Estate of Andrews v. Commissioner, 79 T.C. 938 (1982); and Estate of Lee v. Commissioner, 69 T.C. 860 (1978).
  - vi. The continued attack by the Internal Revenue Service of Minority Interest Discounts in the family context was abandoned by the Internal Revenue Service based on the Family Attribution Theory in Revenue Ruling 93-12, 1993-1 C.B. 202.
  - vii. The Internal Revenue Service essentially conceded the position that family members who hold Minority Interests in a closely held family entity might conceivably not act together.
  - viii. The Service was forced to acknowledge the reality of the situation in which family members often have differing views of how an entity should be managed and, therefore, Minority Interest Discounts where

Minority Interests are held by family members have been acknowledged by the Internal Revenue Service to be real.

- ix. Minority Interest Discounts are equally applicable with respect to Limited Liability Companies and Family Limited Partnerships.

D. Valuation of FLP and LLC Interest.

1. In addition to Minority Interest Discounts, there are valuation discounts which apply in the case of Family Limited Partnership and Limited Liability Company interests which generally fall into two categories.
2. The first set of discounts deal with the lack of marketability of the interest itself.
  - i. At first blush, the Lack of Marketability Discount appears to be conceptually similar to the Minority Interest Discount.
    - a. That is the lack of control on the part of the owner of the interest to force the entity to deal directly with the interest in the same way that an outright ownership interest of the fractional share would permit the owner to dictate.
    - ii. In fact, however, on close examination there is a significant difference with the respect to the Lack of Marketability Discount.
    - iii. Specifically, the difference lies in the area of the statutory scheme by which these entities are created.
      - a. In the case of both a Family Limited Partnership and Family Limited Liability Company, the interest which is created in the entity by virtue of the statute is not easily transferable.
      - b. Significant restrictions on transfer are allowed under both statutes and with respect to both statutes, a potential transferee of a partnership or Limited Liability Company interest takes the status of an assignee.

- c. Assignee status entitles the holder thereof to receive distributions if any are made from the entity, but otherwise affords the interest holder with far fewer rights than even a limited partner or Limited Liability Company member who has no management rights. With respect to an assignee.
  - 1. there is no ability to vote,
  - 2. no right to demand and receive information concerning the affairs of the partnership or Limited Liability Company,
  - 3. no right under any circumstances to compel dissolution of the entity.
- iv. As a consequence, the interest in the hands of the transferee is a very difficult one.
- v. A transferee is entitled to distributions and an assignee will have their proportionate share of profits reported to them and will incur tax liability for such share of earnings and profits but has virtually no ability to compel cash distributions from the partnership or Limited Liability entity.
- vi. It is interesting to note that in the area of Lack of Marketability, there is an observable difference between a Limited Partnership interest and a membership interest, which has by virtue of the Operating Agreement, no management rights.
- vii. In the case of the Family Limited Partnership, a limited partner by statutory definition has no management rights.
- viii. In the case of the Limited Liability Company member, the statutory default is that all members have management rights.
  - a. Typically, in the case of a Limited Liability Company member who has no management rights, the terms and

conditions of the Operating Agreement are what create the lack of management control.

- b. Because this is the case, and arguably because, the agreement as among the Limited Liability Company members could be changed by agreement at any time, interest in Limited Liability Companies, as a theoretical matter, represent a greater potential for control of a fractional interest and, therefore, arguably are less susceptible to valuation discounts for Lack of Marketability.
- ix. Lack of Marketability Discounts can also be created by restrictions on transfer that are inherent in the Partnership or Limited Liability Company Agreement itself.
- a. Here, however, care needs to be taken so that the language of the Agreement does not fall into a trap for the unwary with respect to valuation discounts under Section 2704 of the Internal Revenue Code.
  - b. As a consequence, the drafter of the Limited Liability Company or Limited Partnership Agreement should carefully consider whether increasing the statutory default restrictions is prudent and in the best interest of their clients in the context of the Family Limited Partnership or Limited Liability Company Agreement.
3. Additional valuation discounts are sometimes available based on the property internal to an entity or the structure of the entity itself.
4. In addition, valuation discounts can also be applicable because of market forces.
5. These inherent discounts can take variety of forms and are typically dependent upon the facts and circumstances. Among these discounts are:

- i. Blockage Discounts for the sale of interest which are publicly traded or which constitute sufficiently large blocks of ownership interest that the market cannot efficiently clear them.
  - ii. Discounts available for liquidation of subchapter C-corporation interests.
  - iii. Discounts for commissions, development costs, and other expenses incident to commercial and residential real estate.
  - iv. Discounts for the risks inherent based on the size or competitive circumstances for small, closely held business are typical discounts which might apply under the circumstances.
6. It is important in valuing Family Limited Partnerships and Limited Liability Companies, which may in turn own interest in marketable securities, real estate, business interest or other property that the characteristics of the property be carefully evaluated. This may lead to significant reductions in value.
7. It is fair to say that the Internal Revenue Service has been hostile to valuation discounts based on Lack of Marketability and facts inherent to various assets over time because of the effect which such discounts have on the transfer tax base.
  - i. The Service initiated its attack on FLP's and FLC's through a series of technical advice memoranda and the Service has concentrated its attacks on situations where:
    - a. liquid assets, such as marketable securities, were transferred to a Limited Liability Partnership or LLC,
    - b. the transferor was elderly, or,
    - c. the transfer was carried out by third parties as agents under a power of attorney or as trustees.
  - ii. The Service's attacks have had mixed success as we will see in the analysis of Section III B below, but a close analysis of those attacks provides good guidance to practitioners in structuring Family Limited

Partnerships and Limited Liability Companies to avoid the potential pitfalls.

8. It is also important to understand the interplay between various valuation discounts and discounts for Minority Interest. Both types of discounts can typically be allowable in the Family Limited Partnership or Limited Liability Company context.
9. The discounts are multiplicative. That is, the discounts inherent to valuation of the interest are applied first and, then to the extent marketability discounts are present, that discount may be applied against the interest after the application of Lack of Marketability discounts.
10. It is also possible that entities in a chain of ownership, where one entity owns another, can provide for nested discounts. That is, discounts at the level of both a Family Limited Partnership or Limited Liability Company and at the underlying ownership level of another closely held entity.

E. Protection of Partnership and LLC Interests from the Claims of Creditors

1. The basic protection which is provided by a family limited partnership or a limited liability company is to compartmentalize the family wealth. Partnership or LLC creditors can reach only partnership assets and the assets of a general partner (which vulnerability may be limited by utilizing a limited liability entity as the general partner such as a corporation or a limited liability company thus protecting the individual partners or limited liability company members from partnership level or LLC level debt). This will be covered in greater detail in Section III A. of this outline.
2. The creditors of the individual partners can reach the partners interest in the partnership but not the partnership assets themselves.
3. The typical way in which a partner's interest would be attacked is through the charging order procedure.
  - i. The charging order is a unique remedy that reflects the entity character of the partnership and which concept is borrowed in the limited

liability company statute. Under the charging order procedure a court may grant a judgment creditor of a partner an order charging the partnership interest of the debtor partner with the payment of the debt. Such an order provides that all distributions which would otherwise be made to the debtor partner are paid to the creditor in satisfaction of the claim.

- ii. In the proper circumstances a court may order the foreclosure of the partnership interest, i.e. where the debt greatly exceeds the value of the partnership interest or when it is unlikely that the partnership distributions will satisfy the debt. (note the recent change in Virginia, which fully articulates the potential foreclosure process).
4. The holder of a charging order has the rights of an assignee in the partnership interest. The assignee of a partnership interest generally is only entitled to receive distributions which may be subject to the discretion of the general partner.
5. If the relevant court allows the creditor to foreclose on (attain ownership of) the partnership interest or LLC interest the creditor will still only have the rights of an assignee.
  - i. Although the foreclosing creditor will have a property interest that could be sold (as opposed to a charging order that is personal to the creditor) it is likely that in order to sell the interest the creditor will have to discount the price of the interest substantially assuming that he can find a buyer in the first place due to the lack of control that characterizes interest in family limited partnerships and LLC's in general and assignee interests in particular.
  - ii. These restrictions and impediment may make the limited partnership or limited liability company interest very unpalatable to creditors.
  - iii. There is an additional feature of partnership taxation that may make partnerships and limited liability companies which elect to be taxed as partnerships that may make partnership interest very unattractive to a

potential creditor. Under federal income tax law a partner (LLC member) is subject to tax on his, her or its share of partnership profits as they are earned regardless of whether such profits have been distributed. In Revenue Ruling 77-137, 1977-1 C.B. 178, the Internal Revenue Service ruled that an assignee of a limited partnerships interest in a limited partnership would be treated as a partner for tax purposes even though he was not admitted to the partnership as a substitute limited partner. According the assignee would be taxable on his share of the partnership income each year even if such income were not currently distributed. Basic income tax principals at least sets up the possibility that a creditor may have some adverse income tax consequences with respect their charging order and action thereon.

6. Some commentators have read the revised Uniform Limited Partnership Act which is adopted with modifications in Virginia and Revenue Ruling 77-137 together as standing for the proposition that the holder of the charging order, who has the rights of an assignee will similarly be subject to tax on the debtor partners share of partnership income each year if such income is not distributed.
  - i. Note however, that Revenue Ruling 77-137 involved an irrevocable assignment of the economic interest in the partnership where as a charging order which has not been foreclosed upon under the Virginia statute, or for which a receiver has not been appointed, is a temporary interest that will terminate when the debt is paid. The better analysis may be that a charging order will not shift the incidence of taxation. Note however, that taking further action under the Virginia Statute such as appointing a receiver or such is foreclosing on the partnership interest will definitely shift the incidence of tax.
  - ii. These characteristics, notwithstanding the recent changes in Virginia which favor creditors, still make limited partnership and limited liability company interest extremely unpalatable assets for a potential

creditor. A creditor has significant procedural hurdles which must be overcome, and still is not able to reach partnership or LLC level assets but can only reach the interest of a partner or member and they proceed at their peril from a tax perspective in doing so.

- iii. Finally, a creditor generally cannot reach partnership assets by commencing an involuntary bankruptcy proceeding against the limited partnership unless the Partnership Agreement or LLC Agreement provides otherwise, which they generally will not, such a proceeding against a limited partner will not result in the dissolution or termination of the limited partnership under the relevant state law.

### III. UTILIZING FLP & FLLC AS ASSET PROTECTION PLANNING TOOLS

#### A. Protection offered by the FLP and LLC Against Creditors

1. Equally important to the goal of asset protection is the protection which is afforded the assets which are transferred into the family limited partnership or family limited liability company against creditors.
2. Direct ownership of the assets by the family would subject the assets themselves to potential claims of creditors. It is important to realize that by creating the family limited partnership or family limited liability company that partnership or LLC assets as subject only to creditors claims at the level of the entity itself, thus, assets can be put into the solution of a family limited partnership or limited liability company, and the assets themselves absent fraudulent conveyance or voluntary conveyance which runs afoul of the Virginia statute will no longer be subject to the claims of creditors.
3. To the extent that assets which produce liability themselves are put into the solution of a family limited partnership or limited liability entity, a tiered structure with subsidiary limited liability companies can insulate from the risk associate with, for example, an operating business or other asset entailing risk, if such asset is not already contained within the limited liability entity.
4. In this regard, a limited liability company which is wholly owned by the family limited partnership or family LLC provides a superior means of insulating non risk laden assets from assets which entail a certain amount of risk, without increasing the tax complexity involved, since single member LLC's are treated as disregarded entities for federal income tax purposes.
5. It is important in performing an appropriate risk analysis, for the purposes of creditor protection, that an asset by asset risk analysis be conducted. The critical distinction however that partnership or LLC creditors can only reach partnership or LLC assets not the assets of individual partners or members, and that partners or members creditors can reach only those assets which are owned by the partners or members is critical to understanding the asset

protection which is available with family limited partnerships and family LLC's.

6. It is important to understand that downstream transferees, i.e. the children, also gain significant creditor protection as a result of owning their interest. This creditor protection can be used to protect them from a variety of potential risks, including risks that assets will be taken from them in the context of a divorce.
7. It is important to understand however that, as is usually the case with the law, that the creditor protection provided by this technique is limited and that the protection afforded will be based upon the facts and circumstances as they appear.

B. Use of FLP and LLC in Lowering Estate and/or Gift Tax

1. Principles

- i. Transfer tax is an excise tax on the privilege of transferring property—this forces the law to take into account all logical transformations of the property on its transfer.
- ii. Once a transfer between family members has taken place any relationship is irrelevant to valuation—FMV definition controls.
- iii. The identity of the remaining partners is relevant to measuring the value of a transfer giving vote and pooling of votes.
- iv. State law not federal tax law governs the rights inherent in a partnership – a transferred interest is an assignee interest:
  - No: Management Rights
  - Withdrawal Rights
  - Limited Information Rights
- v. Federal law is more liberal than state law in recognizing a Partnership as an entity apart from its owners—joint profit motive is all that is required.

2. Problems, concerns and points of attack give us guidance on what to avoid when using these entities to reduce estate by creating valuation and minority interest discounts.

i. Theories Used by the IRS

a. Disregarding the Entity

1. Validity under state law
2. Investment companies and deemed gain
3. Step Transaction Doctrine

b. Gifting Theories

1. Gift on formation
2. Gifts of future interest
3. Indirect gifts

- c. Chapter 14 Attack
    - 1. Code § 2703
    - 2. Code § 2704
  - d. Code § 2036
- ii. Disregarding the Entity
- a. Validity under state law has been a losing argument for the Internal Revenue Service.
  - b. Formation of a family limited partnership as a single testamentary transaction is the theory. See Estate of Murphy v. Commissioner, T.C. Memo 1990-472.
  - c. Other Courts however have rejected this approach because of the valid reasons for forming Family Limited Partnerships.

See Kerr v. Commissioner, 292 F.3d 490 (5<sup>th</sup> Circuit), aff'g 113 T.C. 443 (1999), Strangi I, 115 T.C. 35 (2000),

Jones v. Commissioner, 116 T.C. 11 (2001); and,

Knight v. Commissioner, 115 T.C. 36 (2000)

- iii. Investment Companies and Deemed Gain (Disregarding the Entity for tax purposes.) Under the general rule of I.R.C. § 721(a), the contribution of appreciated property to a partnership does not trigger recognition of capital gains. However, this nonrecognition rule does not apply to gain realized upon the transfer of property to a partnership which would be considered an “investment company” under I.R.C. § 351 if it were a corporation. I.R.C. § 721 (b) As explained below, the general intent of the investment company rules is to prevent parties, each of whom is not diversified, from achieving a tax-free diversification simply by coming together in partnership or corporate form. The definition of an “investment company” was relatively unclear historically, relying on the Treasury Regulations under I.R.C. § 351. Then, in 1996, the I.R.S. amended those regulations to clarify what had been perceived as a safe harbor for certain parties who already are diversified (this approached

was supported by several private letter rulings). Then, in 1997, Congress amended I.R.C. § 351 in an effort to thwart swap-fund promoters and, as a consequence, made it significantly more difficult to create a partnership with marketable securities without triggering gain. Historically, as per the regulations under I.R.C. § 351, a general or limited partnership would be deemed an investment company for purposes of I.R.C. § 721(b), and gain would be recognized, if, after the transfer of assets to the partnership, more than 80% of the fair market value of the partnership's assets, exclusive of cash and nonconvertible debt obligations, were held for investment and consisted of publicly traded securities. Publicly traded securities included interests in regulated investment companies, real estate investment trusts, and the publicly traded securities held by a corporation or partnership in which the subject partnership owned a 50% or greater interest. See 1 William S. McKee, William F. Nelson & Robert L. Whitmire, *Federal Taxation of Partnerships and Partners* ¶ 4.08[1] (2d ed. 1990). There is a *de minimus* exception. The regulations under I.R.C. § 351 have long provided that, if one or more transfers of non-identical assets to a partnership, “taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, such transfers shall be disregarded in determining whether diversification has occurred. Treas. Reg. § 1.351-1(c)(5). Therefore, in many family limited partnerships with respect to which the children or grandchildren make only nominal initial capital contributions as limited partners, no diversification should be deemed to occur, and there should be no recognition of gain. In addition, if a husband and wife contribute different assets to a partnership, there should be no deemed sale treatment because there cannot be deemed sales between husbands and wives, although a two-step process may be necessary whereby the husband and wife, by cross-conveyancing, first obtain a *pro rata* interest in each asset and then fund

the partnership with the newly identical assets. See I.R.C. § 1041 and P.L.R. 90-12-024 (March 23, 1990). In several private letter rulings based on the “old” regulations under I.R.C. § 351, and more recently under the amendments to the regulations under I.R.C. § 351 promulgated in 1996, the Service expanded the situations in which diversification is deemed not to exist. The Service ruled in the letter rulings, and now under the amended regulations (by reference to the tax-free reorganization rules of I.R.C. § 368(a)(2)(F)), that diversification does not exist if the assets contributed by each contributing party (i) do not include as more than 25% of such assets the stock or securities of one issuer and (ii) do not include as more than 50% of such assets the stock or securities of five or fewer issuers. Under the tests, “government securities” are included in total assets (the denominator) but are not included as assets of any one particular issuer (the numerator) (discussed more below). The analysis underlying this diversification exemption is as follows:

- a. The contributed portfolios are already diversified for purposes of I.R.C. § 368(a)(2)(F)(iii);
- b. I.R.C. § 368(a)(2)(F)(ii) is the only place in Subchapter C of the I.R.C. where diversification is defined; and
- c. I.R.C. § 721(b) does not apply in the situation where diversified portfolios are being further diversified. P.L.R. 93-28-035 (Apr. 20, 1993). When promulgated solely by letter rulings, this analysis was not supported by any published authority and definitely went beyond the scope of the “old” regulations. In fact, the I.R.C. § 351 regulations, prior to the amendment on this subject, do not refer to the diversification test in I.R.C. § 368(a)(2)(F)(ii). After 1992, some 40-plus private rulings have been issued involving the contribution by a mutual

fund of its diversified securities portfolio to a partnership. The 1996 amendment to the regulations under I.R.C. § 351 basically adopts the test used by the I.R.S. in its private letter rulings, with an additional provision that allows government securities to serve as a buffer. Specifically, the new regulations provide as follows: [A] transfer of stock and securities will not be treated as resulting in a diversification of the transferor's interests if each transferor transfers a diversified portfolio of stocks and securities. For purposes of this paragraph (c)(6), a portfolio of stocks and securities is diversified if it satisfies the 25 and 50-percent tests of section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F). However, Government securities are included in determining total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests. Treas. Reg. § 1.351-3-1 (b)(6)(i). In its notice of proposed rulemaking, the Service provided as follows: The Service wants to clarify that § 1.351-1(c)(5) does not prevent tax-free combinations of already diversified portfolios, and that combinations of already diversified portfolios are not inconsistent with the purposes of section 351(e)(*i.e.*, preventing the tax-free transfer of one or a few stocks or securities to swap funds). Pro. Treas. Reg. § 1.351-1, 60 Fed. Reg. 40795 (1995). After the IRS clarified this area of the law by amending the regulations, Congress tightened the reins

significantly with the Taxpayer Relief Act of 1997 by redefining what counts as a “stock or security” under I.R.C. § 351(e). In particular, whereas, under prior law, closely held stock, precious metals, and the like allowed co-venturers to satisfy the 80% test rather easily, the new law closes that door and, under I.R.C. § 351(e)(1)(B), counts as stock or securities all of the following: (i) money; (ii) stocks and other equity interests in a corporation (not just publicly traded), evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivative; (iii) any foreign currency; (iv) any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly traded partnership or any other equity interest which is readily convertible into or exchangeable for any asset described in clauses (i) through (v) and in regulations (none of which have yet been offered); (v) except as provided in regulations (none of which have yet been offered), any interest in a precious metal; (vi) except as provided in regulations (none of which have yet been offered), interest in any entity if substantially all of the assets of the entity consist of any of the foregoing or any asset specified in regulations; and (vii) to the extent provided in regulations (none of which have yet been offered), any interest in any entity not described in clause (vi), but only to the extent of the value of such interest attributable to assets listed in clauses (i) through (v) and in regulations (none of which have yet been offered).

#### iv. Step Transaction Doctrine

The Internal Revenue Service will sometimes use the Step Transaction Doctrine in cases where the time between finding of the entity and gifting is short or in cases where the sequence of funding and gifting is confused or incorrect. The cases which have been decided recently in this area have begun to crystallize into a need for risk of loss, or for the passage of time between funding and gifts of interest that allows the assets in the entity fluctuate in value.

a. Recent key cases are

1. Sheperd v. Commissioner, 283 F. 3rd 1258 (2002)  
(11th Circuit court of Appeals)
2. Sunda v. Commissioner, 433 F. 3<sup>rd</sup> 1044 (2006) (8<sup>th</sup>  
Circuit Court of Appeals)
3. Holman v. Commissioner, 130 T. C. 170 (2008)
4. Gross v. Commissioner, T.C. Memo 2008-221
5. Heckerman v. U.S., 104 AFTR 2<sup>nd</sup> 2009-551
6. Ludwick v. Commissioner, T.C. Memo 20104-104
7. Linton v. U.S., 630 F. 3<sup>rd</sup> 1211 (2011) 9<sup>th</sup> Circuit Court  
of Appeals
8. Mitchell v. Commissioner, T.C. Memo 2011-94

b. These cases share the common elements of improper sequencing and/or insufficient time for risk of loss to occur.

1. The sequencing of the transaction needs to be correct, this is a problem both for step transaction doctrine purposes and to avoid the gift on formation argument.
2. How much time is enough to create the risk of loss is based on facts and circumstances, but first and foremost by the type of property and volatility of its price or value over the time period in question.

3. 5 of these cases give the Internal Revenue Service arguments which have renewed the viability of the step transaction doctrine in family LP and LLC cases.
- c. 3 Test for Step Transaction Doctrine
1. End results test – asks whether a series of steps were under taken to reach a particular result and, if so, treats the steps as one. See *hinton*, supra.
  2. Interdependence Test – whether on a reasonable interpretation of objective facts the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. See *Linton and Holman*, supra.
  3. Binding Commitment Test – whether at the time the first step of a transaction was entered into, there was a binding commitment to take the later steps.
- v. Gift Taxes on creating a family limited partnership — getting the benefit of the transformation. There are three requirements of a taxable transfer, all of which must exist before any transfer tax can be imposed:
- a. The transferor did not enter into a transaction that is bona fide, at arm's length and free from donative intent (you need a “transferor”).
  - b. The transferor must have been able to control what the hypothetical willing buyer would receive from the transferor in the transaction (you need “an effective transfer of title or other economic interest or benefit in property having the quality of a gift”).
  - c. A transferee's net worth increased as a result of the transaction (you need a “transferee”). If any one of those elements is missing, a taxable transfer does not occur.

However, under this analysis, a traditional gift, bequest, or devise would be a taxable transfer, as would be a bargain sale. However, it would appear that all three elements are missing with the creation of a pro rata partnership.

- d. If any one of those elements is missing, a taxable transfer does not occur. However, under this analysis, a traditional gift, bequest, or devise would be a taxable transfer, as would be a bargain sale. However, it would appear that all three elements are missing with the creation of a pro rata partnership.
- e. The creation of a pro rata partnership does not meet the first requirements of a taxable transaction: The transferor did, in fact, enter into a transaction that is a bona fide, at arm's length and free from donative intent. The first requirement of a taxable transfer is that a person must, in fact, act like a transferor. Thus, if a person enters into an investment that is bona fide, at arm's length, and free from donative intent, there is no taxable gift, even if (i) he is in control of what the hypothetical willing buyer would receive from the transferor in the transaction and (ii) another party (including the objects of his bounty) receives a benefit. Whether this requirement exists is determined by I.R.C. § 2512(b). That statute provides that "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift." I.R.C. § 2512(b). Likewise, Treas. Reg. § 25.2512-8 provides as follows: Transfers reached by the

gift tax are not confined to those only which contravene without a valuable consideration, in accordance with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth. Assume a partner could only sell his partnership interest to a hypothetical willing buyer for 50% of the value of his partnership contribution. Has that partner made a gift to the other partners of the partnership when he participates in its creation because he did not receive (adequate and full consideration" under I.R.C. § 2512(b)? The "ordinary course of business" provision under Treas. Reg. § 25.2512-8 defines certain business transactions as being deemed to meet the "adequate and full consideration" standard under I.R.C. § 2512(b). A transfer made for less than adequate and full consideration, even though ordinarily subject to tax, is not taxed if made "in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent). Treas. Reg. § 25.2512-8. In *Stern v. United States*, 436 F. 2d 1327 (5<sup>th</sup> Cir. 1971). the Fifth Circuit, holding that political campaign contributions were not gifts, stated as follows: In a very real sense, then, [the contributor] was

making an economic investment that she believed would have a direct and favorable effect upon her property holdings in New Orleans and Louisiana. These factors, in conjunction with the undisputed findings of the lower court that the expenditures were bona fide, at arm's length and free from donative intent, lead us, in light of what we have said above, to the conclusion that the expenditures satisfy the spirit of the Regulations and are considered as made for an adequate and full consideration. *Id.* at 1330. In other contexts, Treas. Reg. § 25.2512-8 has been interpreted in the same way. See, e.g., *Shelton v. Lockart*, 154 F. Supp. 244 (W.D. Mo. 1957); *Messing v. Commissioner*, 48 T.C. 502 (1967); *Beveridge v. Commissioner*, 10 T.C. 915 (1948). In *Rosenthal v. Commissioner*, 205 F.2d 505 (2<sup>nd</sup> Cir. 1953). the Second Circuit concluded that “even a family transaction may for gift tax purposes be treated as one ‘in the ordinary course of business’ as defined in this Regulation [25.2512-8] if each of the parenthetical criteria is fully met.” *Id.* at 509. Generally, a pro rata partnership is a bona fide arrangement. As noted above in Section II, numerous bona fide reasons exist for creating a partnership in the family context. Assuming the terms of the partnership are substantially similar to the default state law provisions of the relevant state, those terms should also be considered to be terms under which arm's length parties would agree to do business. Similarly, if the terms of the agreement apply to all partners, then those terms which apply restrictions to the original partners of a partnership should be free from donative intent. Thus, the

creation of a pro rata partnership should not be considered a gift, even if a hypothetical willing buyer would not pay the same consideration to an original partner that the partner contributed to the partnership, because that original partner would not be considered a transferor under the “ordinary course of business” exception under Treas. Reg. § 25.2512-8. The Internal Revenue Service has tried 3 theories all variations of one another with respect to Gifts.

- f. Gifts of formation which has been largely unsuccessful See e.g. Jones, Supra, Church v. United States 268 F.3rd 1063 (5<sup>th</sup> Circuit 2001), Kerr, Supra., Shepherd 115 T.C. 376, 115 T.C. 376 and Strangi I, Supra.
- g. Gifts of future interest used in denying the annual exclusion as in Hackl v. Commissioner, 118 T.C. No. 14 (2002).
- h. Indirect gifts where the latest case, Senda v. Commissioner is significant.

1. The Facts

In 1997, Mark Senda received \$5-6 million worth of MCI stock. He formed two family limited partnerships: one in April 1998 (SFLP 1) and one on December 2, 1999 (SFLP II). His revocable trust was the general partner and had nearly all the limited partner interests of both partnerships; his wife and trusts for his three children held the balance of the limited interests, which were minimal.

On December 28, 1998, Mr. Senda and his wife funded SFLP I with MCI stock from their joint

brokerage account. The same day, the Sendas gave each child's trust limited partner interests, which they reported at \$462,379 on their 1998 gift tax return. On December 20, 1999, the Sendas funded SFLP II with MCI stock. Again on the same day, they gave each child's trust limited partner interests, which they reported at \$183,792 on their 1999 gift tax return. Over a month later, on January 31, 2000, they gave the trusts additional SFLP II limited partner interests, which they reported at over \$14,308 on their 2000 gift tax return. All of the gifts reflected a discount because the limited partner interests were unmarketable and represented minority holdings. The Service issued a deficiency notice for each of the three years in question and said that the value of the property transferred to the children was nearly \$1.8 million for 1998, \$800,000 for 1999 and \$165,000 for 2000. In other words, the Service ignored the partnership discounts and simply focused on the value of the underlying property. The Sendas disagreed and went to Tax Court. They argued that the partnerships had economic substance and should not be ignored. While the Service did not dispute the validity or economic substance of the partnerships, it maintained that the stock transfers to the partnerships were really indirect gifts to the children, and that "the transitory allocations to petitioners' capital accounts, if such allocations

even occurred at all, were merely steps in integrated transactions intended to pass the stock to the petitioners.”

2. The Tax Court Decision

Judge Mary Ann Cohen found Mr. Senda’s testimony regarding the transfers “evasive”. She also observed that: petitioners (the Sendas) were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of FLPs. Indeed, petitioner, as general partner, did not maintain any books or records for the partnerships other than brokerage account statements and partnership tax return. Those tax returns were prepared months after the transfers of the partnership interests. Thus, they are unreliable in deciding whether petitioners transferred the partnership interests to the children before or after they contributed the stock to the partnerships. The same is true of the certificates of ownership reflecting the transfers of the partnership interests, which were not prepared until at least several weeks after the transfers. The informality is not surprising, inasmuch as petitioners alone, individually, or on behalf of their minor children were united in purpose and acted without restraint by any adverse interest. As a result, however, petitioners have presented no reliable evidence that they contributed the stock to the partnerships before they transferred the

partnership interests to the children. At best, the transactions were integrated (as asserted by respondent [the IRS] and, in effect, simultaneous.)

3. Comments

So what was wrong with this picture? After all, the Sendas had created entities that the IRS acknowledged were valid and had economic substance. Why wasn't that enough? Because there were some serious omissions. According to Judge Cohen, the partnerships lacked certain formalities, such as separate books and records, no annual financial statements and no meetings. It was also unclear, the judge stated, that the stock was ever allocated to the Sendas' respective capital accounts. That, plus the timing of the 1998 and 1999 gifts, which occurred on the same day the Sendas funded the partnerships, meant that the transactions were one. Could anything have been done differently? Well, yes. It would have been helpful, for example, to observe some of the entity formalities that Judge Cohen said were missing. If they had been there, she might have been less skeptical of the arrangement. But what about the timing issue? The 1998 and 1999 gifts were held to be integrated transactions, the 2000 gifts were not. Those gifts, which occurred more than a month after SFLP II was funded, were respected. So here's the question: how much time *should* elapse between a transfer in and a gift out? In other words, suppose the partnership

had impeccable records, and the stock transfers to the Sendas' capital accounts were carefully documented. If the gift nevertheless occurred on the same day as the capital allocation, would it have been respected, or would have been seen as part of an integrated transaction? While there is no clear answer to this query, the "old and cold" rule of thumb comes to mind. In other words, a little bit of distance between two transactions is not a bad thing. Applying that notion to this case, perhaps you could say that the 1998 and 1999 gifts were fresh out of the oven, while the 2000 gifts were room temperature. If you create a separate entity, respect it as such, and be meticulous in your record-keeping. Make sure that time elapsed between creation of an entity and transfers of interests. *Senda v. Commissioner*, 2004-160, No. 17298-02, 7/12/04 and *Senda v. Commissioner*, 433 F. 3<sup>rd</sup> 1044 (2006) (8<sup>th</sup> Circuit Court of Appeals.)

- vi. Chapter 14 and Attacks under § 2703 and 2704
  - a. Want to avoid the possibility that the partnership agreement, certain terms or a retained interest would be ignored for purposes of valuing partnership interest.
  - b. I.R.C. § 2701 Senior and junior equity interests if transferred create zero value unless the junior equity is retained or, transferred and retained interests were identical or proportional. Congress passed I.R.C. § 2701 because it was concerned with certain valuation abuses that would not be possible with its companion repeal of I.R.C. § 2036(c)

that could occur through the potential shift of value from one class of equity to another by the reason of the nonexercise of certain retained rights. As a consequence, if the potential for that abuse does not exist, Congress provided for exceptions to the application of the I.R.C. § 2701 valuation rules. For instance, if a senior equity interest is transferred and a junior equity interest is retained, Congress did not feel that a potential valuation abuse could occur. *See* I.R.C. §§ 2701 (c)(1)(B)(i); 2701 (c)(2)(A). This potential valuation abuse also would not exist if the distribution rights of the transferred and retained interests were identical or proportional, even if there is a difference between the transferred and retained interests with respect to voting, management rights, or liability rights (in the case of partnerships). *See* I.R.C. §§ 2701 (a)(2)(B); 2701 (a)(2)(C). The differences with respect to management and liability must be non-lapsing unless the lapse is caused by state or federal law. Thus, in a pro rata partnership, transfers by a general partner of a limited partnership interest will not be affected by the valuation rules of I.R.C. § 2701, even when there may be slightly different economic interests because of the application of I.R.C. § 704(b), as long as the partnership is a pro rata partnership. *See* P.L.R. 94-15-007 (Jan. 12, 1994); P.L.R. 94-27-023 (Apr. 11, 1994). Thus only in those cases where the practice or operation of a pro rata partnership is not pro rata (*e.g.*, the partnership continually distributes cash to only one partner, even though the terms of the partnership call for pro rata distributions) does the potential for this I.R.S. attack exist for the pro rata partnership.

- c. I.R.C. § 2703 While under certain circumstances the Service can disregard certain provisions in a partnership agreement which restrict the transfer or use of the partnership interest, it does not permit the Service to disregard the existence of the Partnership or the fact that a partnership interest was transferred. Thus while Buy-Sell Agreements options and other provisions are potentially subject to challenge, minority interest, lack of marketability and lack of management control discounts are still available (a) if the provisions constitute a “bona fide arrangement” or (b) are not a “device” to transfer property to members of the family for less than full and adequate consideration in money or money’s worth then § 2703 does not apply. e.g.: transferred interest is an assignee interest.
- d. I.R.C. § 2704 Avoiding the lapse of voting or restriction rights with respect to a transferred interest. The Partnerships does not want to have rights lapse at the death of a transferor. Assignee status of the transferee will usually solve this problem. See IRC 2704(a). Also note that under § 2704(b) if the restrictions in a partnership agreement are no more restrictive than the default state laws or are restrictions that unrelated parties would normally bargain for then § 2704(b) does not apply (also the tests of § 2703 would be satisfied). Thus default to statutory structures can avoid the deemed transfer rules.
- e. Internal Revenue Service Attacks  
§2703 the Services arguments have not worked very well. See Strangi I, supra, and Church, supra because of the valid formation of the partnership under State law principals.

§2704 is more problematic but so long as the restrictions imposed are not more restrictive than State law the Service has had limited success. See Kerr, supra, Harper v. Commissioner T.C. Memo 2000-202 (2000).

- vii. IRC §2036 and recent developments (the Current and Real Concern).

The Internal Revenue Service has continued to attack Limited Partnerships and has had some recent success utilizing IRC §2036 which deals with powers retained by a transferor being used as a means of recapturing interests which are purportedly transferred away. The Service's successes and failures in this area illustrates how this Code Section which has long been ignored in the analysis of limited partnerships, has been a dynamic area for change in the last several years.

- a. Basic § 2036 Analysis

§ 2036 provides 2 potential points of attack based on retained interest:

1. § 2036 (a)(1) retained possession or enjoyment of property transferred;
2. § 2036 (a)(2) the right to designate who would possess or enjoy it.

In Tax Court Judge Cohen found both an (a)(1) and (a)(2) problem with Strangi. Also Judge Cohen found that there was no fiduciary duty on the part of the general partner to promote interests of the minority owners (de minimus other interests) where general partner has such a duty then the implied agreement fails. See Byrum.\*

Under US v. Byrum, 408 U.S. 125 (1972) a decedent retains possession or enjoyment of property if the

dependent retains a “substantial present economic benefit” from the property as opposed to a contingent benefit. Also, there must be an express or implied agreement at the time of the transfer that the transferor will retain possession or enjoyment. Treas. Reg. § 20.2036-1(a)(ii).\*

Exception to § 2036 (a): (i) bona fide sale; (ii) for full and adequate consideration. Per Wheller v. U.S., 116 F.3<sup>rd</sup> 749 (5<sup>th</sup> Cir. 1979) have a bona fide sale if the entity serves a substantial business purpose or other non-tax purpose.

Note: Normally have full and adequate consideration because Partnership Interests are taken back for the property.

b. Summary of 2036 Cases to Date

1. Some 3 dozen cases have now been decided with an approximate 1 to 2 ratio of decisions for taxpayers versus the government.
2. The cases decided for taxpayers have found a bona fide Sale exception which in turn have been based on substantial business and other non-tax reasons for the creation of the entities.
3. Taxpayer favorable cases have good facts and circumstances that demonstrate non-tax valid business reasons based on the assets contributed to find a valid business purpose.
4. Taxpayer favorable cases of note – Church, Stone, Kimbell, Bongard, Schutt, Mirowski, Miller, Keller, Murphy, Black, and Shurtz.

5. Cases favorable to IRS – Miller, Bongard, Schauerhamer, Richardt, Harper, Thompson, Strangi, Abraham, Hillgren, Bigelow, Edna Korby, Austin Korby, Rosen, Erickson, Gore, Rector, Hurford, Jorgensen, Malkin, and Turner.

c. Where are we?

As a result of these decisions §2036 had become a viable method to be used by the Internal Revenue Service to attack transfers, but before 2036 can apply there must first be a transfer.

Then the analysis will focus on first:

- a. Whether there was an express implied agreement for retained possession or enjoyment (§2036(a)(1) or,
- b. Whether there are legal enforceable rights which limit or restrain the Grantor of a limited partnership sufficiently to avoid having the interest transferred be recaptured. §2036(a)(2).

The law is evolving very swiftly in this area. Family Limited Partnerships still remain a valid technique if the lessons of these cases is integrated into their design.

- viii. The following are recommendations which will if implemented help avoid problems with § 2036 and the other attacks detailed here.

1. Avoid gift on formation by having

donor retain control over liquidation of entity. Donor can give controlling interest in general partner after formation. But, this may bring § 2036 into play.

2. Do not insert in the governing documents greater restrictions on transferability and liquidation than available under applicable state law.
3. Have a purpose in creating the entity but be brief in the recitals about the purpose.
4. Keep the governing documents short and simple.
5. Do not include limitations in the governing documents on the fiduciary liability of the general partner or manager.
6. Do not include any provision in the governing documents giving extraordinary powers to the general partner or manager.
7. A structure of a limited partnership with corporate general partner may offer advantages over a limited liability company. Otherwise, select a general partner or manager that will not die.
8. Do not contribute personal use property (a personal residence or other personal use property) to the partnership or LLC.
9. Do not contribute assets needed for the support of the individual to the partnership or LLC.
10. Verify that all property identified as

partnership or LLC property is legally transferred to the partnership or LLC.

11. Be careful in the contribution of voting stock in a family owned and controlled corporation if the person who makes the contribution is also the general partner or manager. Otherwise, § 2036(b) may come into play.
12. Be careful in funding the partnership or LLC with installment notes with built-in capital gain.
13. Review the mortgage document for a “due on sale” clause when funding the partnership or LLC with mortgaged property.
14. Watch the investment company rules when multiple partners or members fund the partnership or LLC with marketable securities.
15. If multiple partners or members are funding the partnership or LLC with property without an ascertainable value, obtain an appraisal so that it is possible to precisely determine ownership percentages.
16. Try to fund the partnership with assets that require active management, though favorable cases do exist regarding partnerships that hold solely passive assets.
17. Limited partners should pay for their partnership assets with their own assets. If they do not have assets, the donors should make gifts and let the gifts gather some age, before creating the partnership.

18. Family members or trusts to whom the client wishes to pass the bulk of the partnership assets should themselves be general partners and participate in the operation of the enterprise.
19. All partners should be represented by counsel and consulted in the preparation of the governing instruments.
20. Consider a provision, like one used in the *Stone* documents, that precludes anyone voting for a general partner through a power of attorney (Contrast the emphasis in *Strangi* that the general partner's son-in-law ran the partnership under a power of attorney).
21. Create and fund the partnership as early as possible, to minimize any appearance that it is testamentary in nature.
22. Have someone else hold all of the general partnership interests, to remove any right to control beneficial enjoyment.
23. Give or sell significant limited partnership interests to others, particularly including trusts with independent trustees.
24. The general partner or manager should report often and regularly to the limited partners or members.
25. Consider making periodic distributions to all partners and members.
26. Calculate capital accounts annually and adjust percentages of ownership for disproportionate additional contributions of capital.

27. Make sure that any compensation paid to a general partner or manager is reasonable.
  28. The general partners should keep detailed contemporaneous records of their activities, and send copies to the limited partners (for information purposes, only).
  29. Have partnership stationery, to assure that the general partner never acts in a different capacity.
  30. Do not make distributions discretionary – either preclude distributions during the donor’s lifetime (preferred), or require distribution of all income.
  31. Create two classes of general partnership interests, one of which has control over distributions, and the other which manages the partnership assets. The donor can then transfer the former, retaining the latter. See Gans & Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*,” 100 Tax Notes 1153 (Sept. 1, 2003). See also sample partnership form in Selected Attachments.
  32. Allow time to pass between creation of partnership and LLC before making gifts.
  33. File a gift tax return and report gift.  
Attach a qualified appraisal of gifted partnership or membership interests.
3. Use of FLP’s
    - i. Discounted Gifts
      - a. Annual exclusion gifts

- b. Use of part of all of the unified credit to reach minority positions
- ii. Magnitude of Discounts
  - a. In several recent Rev. Proc. And PLR's the Service has indicated that it will examine discounts of:
    - 1. Greater than 35% for transfers of partnership interests where the underlying property is illiquid, and
    - 2. Any discounts where the underlying property is "marketable securities".
  - b. However, in both these instances the tax court and others have routinely allowed discounts of 25% to 35%. A partnership interest is not the equivalent of the underlying property for transfer tax valuation purposes.
- iii. Use of FLP's in connection with other planning devices
  - a. In connection with Irrevocable Life Trusts. Under certain circumstances a FLP will facilitate a private split-dollar arrangement because it avoids the transfer for value problem.
    - 1. Background. Generally, gross income of a beneficiary of a life insurance contract does not include amounts received under the contract, if such amounts are paid by reason of the death of the insured. I.R.C. Section 101(a)(1). However, after the initial issuance of the insurance policy, if the policy or any interest therein is subsequently transferred for valuable consideration, by assignment or otherwise, then the income exclusion is limited to an amount equal to the sum of the actual value of such consideration and the premiums or other amounts subsequently paid by

the transferee. I.R.C. Section 101(a)(2). The transfer for value rule does not apply to transfers to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. I.R.C. Section 1019(a)(2)(B). Neither does the transfer for value apply if the transferee's basis in the policy is determined in whole or in part by reference to the basis in the hands of the transferor. I.R.C. Section 101(a)(2)(A).

2. Partner Exception. PLR 199905010. A was the majority shareholder of a corporation which owned a key person insurance policy on his life. A and his wife B are general and limited partners in an investment partnership. Since A plans to retire soon, the corporation no longer needs the policy. A proposes to give to children C and D each a \$10,000.00 limited partnership interest in the partnership of A and B. Thereafter, the corporation will sell the insurance contract to C and D in return for their promissory note equal to the greater of the policy interpolated terminal reserve value of its cash value. After the transfer, C and D plan to borrow against the policy to pay off the note to the corporation.

b. In Succession planning for business entities an FLP or Business Associate LP can be the owner of insurance used to fund cross purchase agreements between shareholders of corporation or partners in a partnership.

C. Creation of Valuation Discounts

1. The creation of valuation discounts conceptually was covered by Section II D of the outline.
2. From the standpoint of creating valuation discounts from a practical standpoint the pitfalls to be avoided from a tax perspective are outlined in outline Section III B.
3. There is considerable concern among commentators that the recent trend with respect to the recent decisions in the Tax Court and elsewhere may represent a change in thinking with respect to the reasoning. Heretofore it had been apparent that taxpayers were enjoying a steady stream of victories on other principles, and until the strange decisions because of the reasoning in Byrum there was relatively little concern with 2036(a) would be problematic.
4. It appears that the estate planning uses for Family Limited Partnerships which are detailed in this outline will continue to be viable, subject to some careful planning and examination for appropriate facts and circumstances.

D. Use of Trusts as Limited Partners

1. In the typical design of a Family Limited Partnership or LLC, the Family Limited Partnership or Family Limited LLC is an overlay to the basis estate plan. Such typical estate plan will include among other things, a revocable living trust, which is designed to do an appropriate arbitrage between the unlimited marital deduction and the available credit amount or unified credit against estate tax.
  - i. In the typical design, such a trust, which is already in place in most estate plans, will provide for both a family and marital share. The family trust also being denominated on occasion the by-pass trust and the basic trust design be referred to as an AB trust design.

- ii. While there are significant variations on this basic theme, as well as a number of more advanced techniques which can be folded into such revocable trusts, these trusts share a number of common characteristics.
- iii. A complete discussion of all of the variations with respect to the potential trust employed in a typical tax sensitive estate planning scenario is beyond the scope of the discussion of this course.
- iv. However, there are some characteristics that virtually all of these trusts will have in common, which are important from the prospective of a tax sensitive estate plan.
- v. The first characteristic, which is important, is that these trusts are generally revocable.
  - a. This is important from the standpoint of both creating the trust and transferring property into it because to the extent that the trusts are revocable, transfers of property to the trust will not constitute a completed gift for federal gift tax purposes.
  - b. Revocability of the trust, therefore, delays the day of reckoning because transfers to the trust are not considered to be taxable transfers.
- vi. The second important characteristic, which can be extremely important from the standpoint of planning for family LLC's or Family Limited Partnerships, is that typically these trusts, during the lifetime of the grantor, will be classified for federal income tax purposes as a grantor trust.
  - a. A grantor trust is a trust which has one or more of the characteristics described in Internal Revenue Code Section 671 through 678, which make the trust disregarded for federal income tax purposes as a separate entity.
  - b. Specifically, trusts which have one or more of the grantor trust characteristics described in those code sections are either

treated as tax nullities or, if a tax return is required to be filed under certain circumstances, all the income will be attributed back to the grantor of the trust.

- c. In the case of most grantor trusts, no separate tax return is required to be filed. This is the case because very often, in a typical design, the grantors of the revocable trust are also the trustees, at least initially.
  - d. While a discussion of the grantor trust rules is, again, beyond the scope of this course, the fact that typical tax sensitive estate planning trust documents take on the character of grantor trusts is important from the standpoint of the creation of Family Limited Partnerships and Limited Liability entities.
2. From the perspective of Family Limited Partnerships and Limited Liability Companies, a grantor trust, which owns an interest in a Family Limited Partnership or Family Limited Liability Company, will be deemed to be owned by the grantor.
- i. At the creation of the entities, where we are creating general and limited partnership interest, most particularly, this can be extremely important because a limited partnership interest, which is created initially to be owned by a creator's grantor trust will, for federal gift tax purposes, be deemed to be owned by the trust grantor.
  - ii. This permits a contribution to the limited partnership or limited liability entity without raising the concern that there has been any gift on formation to any third party, because for estate tax purposes, since the trust is revocable, there is no completed gift.
  - iii. And for income tax purposes, because the trust is a grantor trust, there is no shifting of any income interest.
  - iv. As a consequence, this type of trust makes an ideal vehicle to own a limited partnership interest in a Family Limited Partnership, which will not exercise management control.

- v. This is especially important if the creators of the Family Limited Partnership elect to take general partnership interest in their own name as opposed to naming an entity as a general partner.
- vi. Note that for state law purposes, the ownership by a trust of a separate limited partnership is clearly distinct from the grantor of the trust and so it is possible for the grantor to exercise management control as a general partner without converting the limited partnership interest owned by the trust into a general partnership interest for state law purposes.
  - a. From the prospective of state law, a properly created trust, which validly exists under state law, can own any number of types of assets, including a Limited Partnership interest or Limited Liability Company interest.
  - b. Careful drafting of the trust should permit sufficient investment discretion so that a Limited Partnership or Limited Liability Company interest is an appropriate investment for the trust to own, but beyond this relatively simple drafting procedure, there is virtually no impediment which needs to be overcome in the drafting of either the trust itself or the Family Limited Partnership or Limited Liability Company interest.
  - c. Note that in the case of a family Limited Liability Company, there is far less pressure on the separateness of the interest since Limited Liability Company interests inherently limit the liability of their respective owners.
  - d. So, the important consideration from the standpoint of a Limited Liability Company is to simply define in the

Operating Agreement the management rights of various owners under state law.

- e. Thus, in the typical estate plan, the foundational estate planning documents, which include an appropriate revocable trust, are utilized in the design of the Family Limited Partnership or Limited Liability entity to create the separate and distinctive owners required initially to enable the creation of, in the case of a Limited Partnership, limited partnership interests, which are separate and distinct from the creator's of the Limited Partnership who may elect to act as general partners.
  - f. In the case of Limited Liability Company, a separateness for purposes of not violating the management prohibition inherent for limited partners in a limited partnership, is not present.
  - g. But the revocable nature of the trust avoids the potential federal estate tax argument concerning a potential gift on formation.
  - h. Recall that the gift on formation argument permits the Service a point of attack with respect to the transfer of partnership interest and careful design avoids this problem.
3. There is a variation on a theme, with respect to trusts as limited partners, which involves a very specific fact pattern.
- i. In this fact pattern, the estate for which planning is taking place is sufficiently large, that the discounts which are contemplated by the Family Limited Partnership, as well as other planning techniques to be utilized, simply do not provide enough leverage against the estate tax.
  - ii. Typically, this is so because the anticipated estate at death will either be so large that estate taxes are extremely problematic or the estate is

expected to grow substantially over a period of time and a technique needs to be employed which will deter appreciation in the hands of the creator of the Family Limited Partnership.

iii. In this instance it would be possible to employ an alternative technique which would involve, rather than a gifting transfer of Limited Partnership interests, the sale of such an interest to an intentionally defective grantor trust.

a. An intentionally defective grantor trust is a trust which for federal income tax purposes classifies as a grantor trust.

b. That is, it possesses one of the characteristics contained in Section 671 through 678 of the Internal Revenue Code which makes it a grantor trust for federal income tax purposes, but which, nonetheless, is not included in the estate of the grantor.

c. Typically, such a trust would be an irrevocable trust and so, for purposes of gratuitous transfers, a transfer to such a trust without consideration, would constitute a completed gift for federal gift tax purposes and a disposition via state planning instruments would constitute a taxable transfer for estate tax purposes.

d. An intentionally defective grantor trusts, however, would retain its character as a trust whose income is attributed to the grantor. The typical powers which will make a grantor trust for income tax purposes are:

1. First, the power to substitute assets. IRC Section 675(4)(c).

2. Loans to grantors on favorable terms. IRC Section 675(2).

3. Thirdly, power to control beneficial enjoyment of the trust. IRC Section 674(a).
  4. Fourthly, the power to add beneficiaries. IRC Section 674(a).
  5. Fifthly, the power to distribute to grantor's spouse. IRC Section 677(a).
  6. Sixth, the power to pay life insurance premiums. IRC Section 677(a).
- e. In this scenario, such a grantor trust would purchase from the Family Limited Partnership current interest holders a limited partnership interest in exchange for a promissory note given to the interest holder, who could be the creator of the Family Limited Partnership or his or her revocable trust.
1. The promissory note would contain provisions with respect to the payment of principal, as well as appropriate interest provisions and would be structured as an arms length purchase and sale.
  2. The interest would typically be either business or investment interest and the recipient would typically recognize income.
  3. In the case of an intentionally defective grantor trust, the interest income and investment or business interest expense cancel one another out.
  4. In addition, for income tax purposes, the income generated by the Limited Partnership interest would be attributable to the grantor generating an incidence of income tax in the

grantor, which income tax would need to be paid from their other assets. Note, in the intentionally defective grantor trust scenario, the grantor is not a beneficiary of the intentionally defective grantor trust.

5. This provides a scenario in which a significant fraction of a Family Limited Partnership which owns property which is expected to substantially appreciate could be transferred to the subsequent generation via the intentionally defective grantor trust on a highly income tax leveraged basis since the income would be attributable to the grantor and tax would otherwise be paid by the grantor, presumably either from other assets or from remaining distributions from other ownership interests in the Family Limited Partnership.
6. In addition, the installment sale note can be structured in the form of a self canceling installment note, which cancels at the death of the grantor.
7. Provided that the self canceling feature of the installment note is correctly structured, the potential leverage with respect to both the appreciated asset and the remaining asset which is contained in the estate of the grantor is potentially quite significant.
8. It should be clearly understood that this brief description with respect to installment sales to an intentionally defective grantor trust

represents only a thumbnail sketch of the state law and federal tax law principals which are involved.

9. There are substantial and significant traps for the unwary with respect to this advanced technique involving an irrevocable trust and so planning should proceed with quite a bit of care.
10. Note that there are other alternatives with respect to trusts being involved as limited partners which involve the same potential leveraging and use of trust which are not revocable.
11. A potential laundry list of these techniques includes:
  - the use of a grantor attained annuity or uni-trust
  - the use of a grantor retained income trust
  - interfamily installment sales
  - interfamily purchases using self canceling installment notes
  - private annuities
  - and installment gifts.
12. This laundry list of advanced techniques contains similar caveats to the intentionally defective grantor trust scenario and required extensive planning.
13. Potential planner is reminded that there are significant traps for the unwary involved in

E. Control Issues.

1. With respect to control of the Family Limited Partnership, there is a dynamic tension between the goals and objectives of the creator of the Family Limited Partnership, who typically wishes to retain a maximum amount of control over the assets which will be contributed to the Family Limited Partnership and the relevant federal estate and gift tax issues.
2. State law control principals are typically fairly straightforward. In the Family Limited Partnership scenario, the senior generation typically occupies the status of general partners, either directly or indirectly, and successor generations occupy, along with appropriate estate planning trusts, the role of limited partners.
  - i. Care must be taken to design the limited partnership such that the senior generation has appropriate control of the technique as the entity proceeds.
  - ii. It is important to understand that control is typically maintained by the general partners so long as they are general partners.
  - iii. Restrictions on the substitution of general partners in the agreement, which substantially increased the maintenance of control in the hands of the original general partners, are possible under state law.
    - a. In such a scenario, however, the drafting of the Limited Partnership Agreement would be overriding the basic statutory paradigm which permits the Partnership Agreement to specify the mechanism for substituting general partners in such a way that it is more restrictive.
    - b. Typically, one of the matters on which limited partners are entitled to a voice is with respect to votes concerning the management of the partnership itself, i.e., who will act as general partners. While it is

possible under state law to restrict substantially or even eliminate the ability for limited partners to vote with respect to the potential substitution of substitute general partners, such substantial restrictions carry with them the risk that such restrictions might be so severe that it raises the possibility of a potential argument under Chapter 14, Internal Revenue Code Sections 2701 through 2704.

- c. The better structure is to permit appropriate voting on the part of all limited partners to vote as they see fit with respect to substitution of general partners and specify a voting percentage which is required in order to substitute a general partner and then engineer the ownership interest in the partnership such that the original general partners will not, under any circumstances, be unable to vote in such a way as to maintain control.
  - d. Such a scenario which allows the exercise by limited partners of their statutorily created rights to have a voice in the basic management of the partnership, adheres most closely in the family context to the basic statutory scheme which for federal estate tax purposes specifically with respect to potential 2704 attacks is extremely helpful.
- iv. It is clear that there is a dynamic tension in formation of family limited partnerships and that correct formation under state law which maximizes control for the senior generation may, in fact, create tax problems.
3. In the case of Limited Liability Companies, the statute is inherently more flexible. It is for the Operating Agreement to specify under what conditions a

member, who has management authority, either as a managing member or a manager, will be superceded by another manager.

- i. Because of this inherent flexibility, that is, there is no statutory default with respect to management other than that, absent anything to the contrary in the Operating Agreement, all LLC's are member managed by all their members. It is necessary by careful drafting to specify how and under what circumstances the senior generation establishes and maintains control.
  - ii. Note that the inherent flexibility of a Limited Liability Company and the absence of a statutory paradigm in which some owners have management control and others do not with respect to the underlying assets is one of the principal reasons why there is a reasoned argument to be made that, the discounts in the case of Limited Liability Companies should be less significant than they are for Limited Partnership interests in the context of a Family Limited Partnership.
4. Finally, with respect to control issues, there is a significant potential overlay with respect to control which should be carefully considered.
- i. In addition to a potential concern under Section 2704 of the Internal Revenue Code, the Strangi case which is analyzed earlier in this outline raises the concern with respect to control being so great that there are effectively no interests other than the interests of the creators of the Family Limited Partnership.
  - ii. Recall that the Byrum decision, which was decided by a Supreme Court, found fiduciary duties at two levels, specifically, at the level of a corporate general partner and at the level of the partnership itself, to the significant other property interests which were inherent in the Byrum facts.
  - iii. In exercising control, it is important that we do not become overzealous in providing our clients who create these arrangements

with so much control that that fiduciary duty to the other interest holders is completely eviscerated.

- iv. The effect of doing so puts us squarely within the ambit of a potential I.R.C. § 2036 challenge to the arrangement, which would defeat the potential discounts which are otherwise generated in a properly designed Family Limited Partnership. A I.R.C. § 2036 argument is most especially triggered in the management and conduct of the partnership business with respect to income and cash flows.
- v. It is important to understand that while we can and should provide for effective control on the part of the senior generation, nonetheless, the property interest created for the downstream family members needs to be both legally and economically real and should include respecting the entity, and appropriate distributions of the income reported to various partners or members treated as partners.
- vi. The difference between the ability to control the Family Limited Partnership and unfettered discretion to distribute the income in any way which a general partner desires should be emphasized before the arrangement is entered into so that for estate tax purposes, we do not create an entity which is subjected to significant weaknesses from the standpoint of Internal Revenue Code §§ 2701 through 2704 and § 2036.
- vii. There are additional income tax issues which should be carefully considered with respect to the control issue for income taxes purposes which will be dealt with in Part IV of the outline.
- viii. A final point with respect to control is the drafter of the Limited Partnership Agreement or Operating Agreement should take some care to balance the interest, economic and legal, among the various parties to the arrangement. The potential consequences of becoming too clever in the drafting process is that we lose the benefits which we were trying via this technique to engineer for our clients.

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**Asset Protection  
Basic Principles  
and  
Global Overview**

**By: C. Arthur Robinson, II**

- I. Asset Protection
  - A. The structuring of Ownership of assets to defeat or substantial increase the difficulty of creditors attempts to collect on obligations.
  - B. Control rather than ownership of assets is the critical underlying principle to asset protection.
  - C. Main Challenges
    - 1. Fraudulent Conveyance, Va. Code §55-80 to55-105.
    - 2. Voluntary Conveyance, op. cit.
    - 3. In bankruptcy various preferences which can be exercised to void transactions and reclaim assets 11 U.S.C §§547, 548.
- II. Levels of Asset Protection
  - A. 4 Levels of Asset Protection
    - 1. Inherent protections for assets held in certain forms.
    - 2. Use of Family Limited Partnerships and Family LLC in conjunction with trusts and other normal planning techniques.
    - 3. Use of trusts to import the law of a foreign jurisdiction.
      - i. Domestic Asset Protection trusts
      - ii. Foreign (outside of US) Asset Protection Trusts
    - 4. Use of foreign trusts to export the assets to a foreign jurisdiction.
  - B. Inherent Protection

1. Present in some ownership structures for some assets.
2. Protection structures.
  - i. Tenants by the entireties ownership by a married couple.
    - a. Only joint debts reach the property.
    - b. Long established by common law.
    - c. Does not work for federal tax liens.
    - d. Often used in real estate, available but less common for other asset classes.
  - ii. Qualified Retirement Plans
    - a. Blanket protection of assets held inside a Qualified Plan provided by the Employee Retirement Income Security Act of 1974 (ERISA) Codified in scattered sections of 5 U.S.C., U.S.C., 29 U.S.C., and 4 U.S.C.
    - b. Bankruptcy protections for these plans as well 11 U.S.C. §522.
  - iii. Individual Retirement Accounts
    - a. Protection for balances of approximately 1.2MM provided by Va. and Federal bankruptcy statutes. See Va. Code §34-34 and U.S.C. § 522.
    - b. This exemption must be affirmatively claimed.
  - iv. Life Insurance Policies
    - a. Exempt from claims of creditors, Va. Code § 38.2-3122.
  - v. Business Assets Owned by Corporations and other forms which limit liability.
    - a. Many Active businesses are conducted in corporate form or as registered Limited Partnerships or Limited Liability Companies.

- b. These entities limit the liability of owners. See Title 13.1 Chapters 7, 9, 10, 12, 13, & 14.
- c. This authority limits liability in various ways for Profession Corporations, Business Corporations, Limited Liability Companies and Professional Limited Liability Companies. And Virginia Business Trusts.
- iv. Various Statutory Exemptions
  - a. Homestead Exemption, Va. Code §34-4.
  - b. Exemption for Veterans, Va. Code §34-4.1.
  - c. Poor Debtor's Exemption, Va. Code §34-27.
  - d. Agricultural Exemption, Va. Code §34-27.
  - e. Garnishment Exemption, Va. Code §34-29.
  - j. In Estates various allowances Va. Code § 64.1-151.1, 151.2 & 151.3 See after October Va. Code §64.2-309, -310, -311.

C. Family Limited Liability Entities

See additional outline for this section.

D. Domestic Asset Protection Trusts

1. A growing list of states that statutorily permit the creation of self-settled spendthrift trusts – trusts which afford spendthrift protection to the interests of the trust's creator. Twelve states already afford such protection by statute: Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, and Wyoming. Several other states appear to permit these trusts by case law. See, e.g., *Uhl. v. United States*, 241 F. 2d 867 (7<sup>th</sup> Cir. 1957) (Indiana law); *Estate of German v. United States*, 7 cl. Ct. 641 (1985) (Maryland law); *Herzog v. Comm'r*, 116 F. 2d 591 (2d Cir. 1941), *aff'g* 41 BTA 509 (1940) (New York law).
2. Several States are in the process of enacting these statutes as this represents a growing trend in the United States.

3. Virginia recently enacted its own version of this law which can be found at VA. Code § 55-545.03:2 and – 545.03:3.
4. In these states a trust can be created that affords significant protection from creditors.
5. In states which do not have these statutes a trust which has situs in a state with the statutory protections could also afford significant protection.
6. Fraudulent & Voluntary conveyance attacks require that these arrangements be set up proactively, i.e. before liability arises.
7. The question of Federal Preemption in Bankruptcy has been present since these statutes were enacted, and is an open question.
  - i. A partial answer to this question was provided in Battley v. Martensen, Chapter 7 Case No. A09-00565-DMD, Mem Adv. No. A09-90036-DMD (Bkrpt D. Alaska May 26, 2011)
  - ii. In Martensen the Bankruptcy Judge set aside a transfer of real property to an Alaska asset protection trust as a fraudulent conveyance.
  - iii. The court based its ruling on the intent of Mr. Martensen which was to protect the property from his creditors.
  - iv. This is the first case to reach this result and it may be limited on its facts. However it casts doubt on the validity of these state statutes at least in the Bankruptcy context.

E. Foreign (Non US) Trusts used for Asset protection

1. Foreign trusts or their equivalents exist in approximate 30 “Tax haven jurisdictions” around the world.
2. With the advent of the Foreign Trusts Rules and the reporting rules of foreign bank accounts the opportunity to maintain secret accounts and to avoid income taxes have been substantially foreclosed.
3. Two approaches are used with foreign trusts:
  - i. Import the law, i.e. have US assets including Family Limited Liability entities owned by a foreign trust which is subject to the jurisdiction and laws of the country of situs for the trust.

- ii. Export the assets, i.e. have US assets converted or transferred into ownership interests or accounts located offshore and subject only to laws of the offshore jurisdictions involved.
- 4. Planning at this level is fact specific, very complex, involves choice of situs considerations which are very important and is beyond the scope of this presentation.

**THE AUGMENTED ESTATE IN VIRGINIA**  
**OR**  
*If Momma ain't happy, ain't nobody happy*

**BY**

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**I. INTRODUCTION**

On January 1, 1991, the concept of the "augmented estate" became effective as the basis for measuring the forced or elective share of a surviving spouse in the estate of a deceased spouse. Prior to January 1, 1991, the forced share was limited to a fraction<sup>1</sup> of the decedent's net probate estate with respect to personal property plus whatever rights the surviving spouse's dower or curtesy interest gave him or her in the deceased spouse's real estate. Today the same fractions will apply, but to the statutorily defined augmented estate.

Non-vested rights of dower and curtesy as well as existing separate equitable estates were abolished effective January 1, 1991.

Under prior law of dower and curtesy, many practitioners felt that the surviving spouse's forced share was not adequately defined and there were numerous ways to defeat or minimize the election of a forced share and disinherit the surviving spouse.

1. Non-probate transactions such as insurance, joint property, and *inter vivos* trusts were not included in the spouse's forced share;
2. Separate equitable estates in both real estate and personal property were outside the scope of the spouse's forced share;
3. There was no way to make a forced share election in intestacy;
4. Gifts could be used to reduce the decedent's estate and frustrate the surviving spouse's claim;

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<sup>1</sup> One-half (1/2) if the decedent was not survived by descendants and one-third (1/3) if the decedent was survived by descendants.

5. A spouse who had been adequately provided for during lifetime could "double dip" by adding forced share property to property acquired during lifetime, or non-probate property acquired at death;

The concept of the augmented estate was taken from the pre-1990 version of the Uniform Probate Code (UPC). It incorporates concepts from the federal estate and gift tax law in defining the size of the spouse's elective share. Virginia has not adopted the UPC in whole, and has instead adapted parts to existing laws, creating a fairly unique application of "uniform" concepts.

Article Two of the UPC, which included the augmented estate provisions found in Virginia law, was completely revised in 1990. Virginia augmented estate law is based on the UPC provisions prior to the 1990 amendment. For purposes of the discussion that follows, the pre-1990 version will be referred to as the UPC, while the 1990 Revised Uniform Probate Code and later versions will be referred to as the RUPC.

The RUPC revisions to the elective share provisions are substantial. Because of significant changes in concepts and terminology, the RUPC is of limited, if any, benefit in interpreting Virginia law, but, as we will explore in Article XI of this outline, offers some solutions to the problems and issues currently existing in the interpretation and enforcement of the Virginia version of the forced shared rights of the surviving spouse.

The augmented estate provisions in effect in Virginia contemplate a three-stage process:

1. Making and filing the election;
2. Determining the augmented estate; and
3. Satisfying the forced share.

Virginia law provides limited defenses or protection against the forced share election. This outline will explore the current status of Virginia statutory law and the limited judicial interpretation available to the practitioner. It will also illustrate differences in the Virginia system and the RUPC, with the author's suggestions on improving the elective share process in Virginia.

## **II. ELECTION**

1. Under Virginia law prior to 1991, electing a forced share was a relatively simple matter for the surviving spouse. A renunciation of the decedent's will could either be made in person or in writing in the court in which the will was recorded. After that, it became the responsibility of the decedent's personal representative and the owners of the decedent's real estate to resolve the problem of the forced share.
2. The statutes now provide that election may be made whether or not a provision for the surviving spouse is made in the decedent's will or whether the decedent died intestate. Va. Code §64.1-13. A renunciation of the decedent's will is not required. *See Boyle v. Boyle*, 30 Va. Cir. 438 (1993).

3. The election must be made within six (6) months of the later of the time of admission of the decedent's will to probate or the qualification of an administrator on an intestate decedent's estate. Va. Code §64.1-13.
  - a. The election is made either in person before the court having jurisdiction over the administration of the decedent's estate or in an appropriately acknowledged writing recorded in the court or the office of the clerk. Va. Code §64.1-13.
  - b. The time for election may be extended if there is a suit in equity in which there is at issue either (1) the construction of the decedent's will, or (2) the amount or value of the property the surviving spouse will receive, or (3) the value or composition of the augmented estate, and the court orders the extension before the expiration of the initial six (6) month period. The extension may not exceed ninety (90) days from the entry of a final order in the suit. Va. Code §64.1-14.
  - c. The time period for claiming the elective share is shorter than the one (1) year period under prior Virginia law to renounce the will. Additionally, under prior Virginia law, it was possible to get an extension of time of up to six (6) months following the entry of a final order construing the decedent's will. The shortening of the time frame in which to challenge the decedent's disposition of assets is helpful to the personal representative who is required under Federal law to file an estate tax return (Form 706).
4. Problems in the Election Process.
  - a. **Filing.** *Haley v. Haley*, 272 Va. 703 (2006).

After her husband died in 2003, Betty Haley qualified as the administratrix of his estate. Within four (4) months, her attorney signed and filed with the Circuit Court a document intended to claim the widow's elective share in the decedent's estate. This document was not signed by the surviving spouse and further did not bear an acknowledgement.

After the Court sustained a demurrer on behalf of the decedent's son from a prior marriage, Betty Haley personally signed the election for the elective share, had it properly acknowledged and filed it with the Circuit Court fourteen (14) months after qualifying as administratrix. She then filed an amended complaint to determine her elective share of her husband's estate. This amended complaint was the subject of a second demurrer, this time on the basis that the amended claim was not filed within six (6) months of the widow's qualification as administratrix. When the trial court sustained the second demurrer, the surviving spouse appealed.

Haley argued that the requirements of Va. Code §64.1-13 were substantially met when her attorney signed and filed a claim as her agent. The son countered that the terms of the statute were clear and unambiguous, and that any "notice" he may have regarding the spousal election was irrelevant in determining if the election was valid.

The Supreme Court, citing prior case law, stated that where statutory law is “clear and unambiguous, we apply the statute according to its plain language.” (292 Va. 703, 707) The Supreme Court found the provisions of Va. Code §64.1-13 to be clear and unambiguous and that to claim the elective share “the claimant must strictly comply with the requirement set forth in the statute” (*Id.* at 707). Because the claim filed by the spouse’s attorney did not bear the required acknowledgement or proof required for a writing to be admitted to record under Virginia Code §55-106, it was ineffective as a matter of law to claim the elective share.

The Supreme Court also went on to address the widow’s other argument and found that “actual notice” and substantial compliance are not enough to satisfy the statutory requirements of Va. Code §64.1-13, which requirements are mandatory.

Because of the ruling that the original filing did not strictly comply with the statutory requirement on acknowledgement, the Court did not address the issue of whether an attorney can make a claim of election under Va. Code §64.1-13.

b. **Agency.** The only case involving powers of an agent to renounce a will on behalf of an incapacitated spouse was decided under prior law. In *First Nat’l Exch. Bank v. Hughson*, 194 Va. 736 (1953), the Supreme Court held that a guardian or committee was conferred no power to renounce a decedent’s will, but that a Circuit Court could, after consideration of certain factors, renounce a will on behalf of an incapacitated surviving spouse.

In *Hughson*, Nellie Stone was the incompetent widow of Dr. Eustace B. Stone, deceased. First National Exchange Bank of Roanoke, as Nellie’s guardian, sought to renounce the provisions made in Dr. Stone’s will for his widow and to deliver unto her the portion of her husband’s estate to which she was entitled under the law of Virginia then in effect. In response, parties interested in Dr. Stone’s estate proposed alternative plans to establish a special trust for Nellie which would pay to the Bank, as guardian, so much of the principal as needed for Nellie’s support, with the remainder to pass to four legatees as nearly in accordance with the terms of the will as possible. When the trial court approved and adopted one of the alternative plans, the Bank, as Nellie’s guardian, appealed.

The guardian contended that it possessed the power to renounce the will on behalf of Nellie, the surviving spouse. The executor and legatee of the estate maintained that such right of renunciation is personal to the spouse, and the guardian could neither exercise the power nor demand as of right renunciation of the court.

The Supreme Court of Virginia, after review of the history of the statutory spousal renunciation rights found “no purpose or interest to give the guardian or committee of an insane widow or widower the power to renounce the provisions of a will made for her or him, and thus, clearly there is no implication that can be justly drawn from the language that would confer such a power” (*Id.* at 805)

The Court found that the power to renounce provisions of a will made for an incompetent spouse must be exercised on behalf of the incompetent spouse by a court of equity, taking into account what is in the best interests of the incompetent spouse.

In at least two Circuit Court cases, “In the matter of The Estate of Joseph W. Rowell, Deceased” File No. 92.12 in the Circuit Court of Isle of Wight County and in “Midgette v. Midgette” CH-01-1970 in the Circuit Court of the City of Virginia Beach, it has been held that an attorney-in-fact under a durable power of attorney may elect the augmented estate claim on behalf of the surviving spouse. See J. Rodney Johnson, “The Augmented Estate v. Property Rights at Death.” A Virginia Handbook, 1995 for more detail on the *Rowell* case, where the surviving spouse was competent at the time the election was made. In *Midgette*, the surviving spouse was not competent when the claim was made by the agent under her durable power of attorney.

This author has received anecdotal evidence of other instances in which an agency relationship was successfully employed to make the elective share claim, but to date, the Virginia Supreme Court has not ruled on this issue.

A conservator is specifically authorized to make an augmented estate claim on behalf of an incapacitated ward under the provisions of Va. Code §37.2-1023(A)(6). The proposed Uniform Power of Attorney Act includes a provision in Va. Code §26-72.11(2) that allows an Agent to: “Demand or obtain money or another thing of value to which the principal is, may become, or claims to be, entitled by reason of the fund, by litigation or otherwise.”

c. **Capacity.** In *Jones v. Peacock*, 267 Va. 16 (2004), the issue of capacity to make the elective share claim was brought before the Virginia Supreme Court.

At the time of his wife’s death in 2000, Franklin Jones resided in a retirement home. Three months after his wife’s death, Franklin was moved to the nursing home level of care due to his refusal to eat, drink or take his medications and because he expressed a desire to die coupled with wrapping a call bell cord around his neck. He was 90 at the time.

Two days later, Franklin signed a Notice of Claim for Elective Share, had it acknowledged by a notary public, and his son thereafter filed a claim with the Circuit Court the same day. Two days later, Franklin died.

The executor of Mrs. Jones estate filed a bill of complaint for advice and guidance asserting that the claim was invalid due to Franklin’s lack of competency. The executor claimed that the recording requirements of Va. Code §64.1-13 made the claim analogous to a contract and therefore the mental capacity required to execute a contract was required to validly execute an elective share claim. Franklin’s son argued that the claim was analogous to a testamentary document, and should be judged under the standards of capacity necessary to execute a will. They also argued that despite the standard chosen, Franklin was competent to make the elective share claim.

The Circuit Court, focusing on the acknowledgment provisions of Va. Code §64.1-13, found a similarity of the claim for the elective share to contracts and deeds and held that Franklin did not understand the nature of the claim or the consequences of signing it and held the elective share claim invalid.

On appeal, the Supreme Court disagreed, finding that the references to Title

55 address only the form a document must meet in order to be admitted to record, and does not establish a level of competence required to execute an elective share claim.

The Supreme Court agreed with the proposition gleaned from cases from other jurisdictions that executing an elective share claim was not the same as executing a contract or a will. In fashioning its definition of competence, the Court held that:

at the time an election is made under Code §64.1-13, the surviving spouse must have the capacity to understand his right to elect against the will and receive a share of the estate established by law and to know that he is making such an election. Competency to execute the notice of claim does not require a surviving spouse to know the specific amount that will be received as a result of such election. *Id.*  
at 21

The Supreme Court also began a factual investigation into Franklin's competency by establishing a presumption that all persons are competent and by placing the burden of establishing incompetency on the challenging party. The Supreme Court found nothing in the testimony of Franklin's physicians that indicated that Franklin lacked the ability to understand his right to claim an elective share or to know that he was executing a claim. The Justices concluded that the executor failed to meet the burden of establishing incompetency and reversed the trial court's findings.

### III. DETERMINATION

1. **Amount.** If a claim for an elective share is made, the surviving spouse shall, if the decedent left surviving children or their descendants, have one-third (1/3) of the decedent's augmented estate; or if no children or their descendants survive, the surviving spouse shall have one-half of such augmented estate.
2. **Interest.** The surviving spouse shall be entitled to interest at the legal rate specified in Va. Code §6.1-330.53 from the date of the decedent's death to the date of satisfaction of the elective share. Currently, the rate of interest is six percent (6%).
3. **Property Included.** The augmented estate includes all of the decedent's probate assets (whether by testate or intestate succession), real and personal, remaining after payment of all allowances, exemptions, funeral expenses, charges of administration (excluding federal or state transfer taxes) and debts, to which is added the following:
  - a. The value of property (other than tangible personal property received by gift and the proceeds thereof) owned or acquired by the surviving spouse at the decedent's death to the extent the property is derived from the decedent (other than by will or intestacy) without a full consideration in money or money's worth. Va. Code §64.1-16.1(1).

- b. The value of property (other than tangible personal property received by gift and the proceeds thereof) the surviving spouse derived from the decedent other than by will or intestacy, without full consideration in money or money's worth, which the surviving spouse transferred at any time during the marriage to someone other than the decedent and which would have been included in the surviving spouse's augmented estate had that spouse predeceased the decedent. Va. Code §64.1-16.1(2).
- c. The value of property transferred to anyone other than a bona fide purchaser by the decedent during the marriage to the surviving spouse to or for the benefit of any person other than the surviving spouse, to the extent the decedent did not receive adequate and full consideration in money or money's worth for the transfer, if the transfer is any of the following. Va. Code §64.1-16.1(3).
  - (1) Any transfer under which decedent retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death, the possession, enjoyment or right to income from the property.
  - (2) Any transfer to the extent that the decedent retained for his life, for any period not ascertainable without reference to his death or for any period which does not in fact end before his death, a power, either alone or in conjunction with any other person, to revoke, consume, invade or dispose of the principal for his own benefit.
  - (3) Any transfer whereby property is held at the time of the decedent's death by the decedent and another with right of survivorship.
  - (4) Any transfer to or for the benefit of a donee within the calendar year of decedent's death, or any of the five (5) preceding calendar years, to the extent the aggregate transfers to any donee exceed \$10,000.00 in that calendar year.

#### **4. Terminology.**

- a. *“Derived from decedent.”* The term “derived from decedent is not defined in the Virginia statute but is broadly defined under the UPC as including, but not being limited to, “any beneficial interest of the surviving spouse in a trust created by the decedent during his lifetime, any property appointed to the spouse by the decedent’s exercise of a general or special power of appointment also exercisable in favor of others than the spouse, any proceeds of insurance (including accidental death benefits) on the life of the decedent attributable to premiums paid by him, any lump sum immediately payable and the commuted value of the proceeds of

annuity contracts under which the decedent was the primary annuitant attributable to the premiums paid by him, the commuted value of amounts payable after the decedent's death under any public or private pension, disability compensation, death benefit or retirement plan, exclusive of the Federal Social Security system, by reason of service performed or disabilities incurred by the decedent, any property held at the time of decedent's death by decedent and the surviving spouse with right of survivorship, any property held by decedent and transferred by contract to the surviving spouse by reason of decedent's death and the value of the share of the surviving spouse resulting from rights in community property in this or any other state formerly owned with the decedent. Premiums paid by the decedent's employer, his partner, a partnership of which he was a member, or his creditors, are deemed to have been paid by the decedent." UPC Section 2-202.

- b. *"Bona Fide Purchaser."* The definition of "bona fide purchaser" is not defined in the elective share statutes, but was included in Va. Code §64.1-01 of the Virginia Code in 1992 to address the concerns of title insurers who continued to require spousal signatures on deeds. Va. Code §64.1-01 defines bona fide purchaser as "a purchaser of property for value who has acted in the transaction in good faith. Notice of a seller's marital status, or notice of the existence of a premarital or marital agreement, does not affect the status of a bona fide purchaser. Under the Uniform Marital Property Act, Sec. 9, 9A ULA 120 (1987), a "purchaser" is one who acquires property by sale, lease, discount, negotiation, mortgage, pledge, or lien or who otherwise deals with property in a voluntary transaction, other than a gift. A purchaser gives "value" for property acquired in return for a binding commitment to extend credit to the transferor or another as security for or in total or partial satisfaction of a pre-existing claim, or in return for any other consideration sufficient to support a simple contract." Note that the bona fide purchaser exception to inclusion in the augmented estate was eliminated in the RUPC.
- c. *"Full and adequate consideration."* Full and adequate consideration is not defined under the Virginia Code.
- d. *"Estate" and "property"*. The Virginia Code defines the terms "estate" and "property" to include insurance policies, retirement benefits exclusive of federal social security benefits, annuities, pension plans, deferred compensation arrangements, and employee benefit plans to the extent owned by, vested in, or subject to the control of the decedent on the date of his death or the date of an irrevocable transfer by him *during his lifetime*.

- 5. **Inclusion of Benefits.** Property for purposes of the augmented estate includes insurance and retirement benefits *excluding social security*, annuities, pension plans,

deferred compensation arrangements, and employee benefit plans to the extent owned by, vested in, or subject to the control of the decedent on the date of his death or the date of an irrevocable transfer by him during his lifetime. Va. Code §64.1-16.1 (emphasis added).

- a. See *Felix-Aranibar v. Felix*, 59 Va. Cir. 357 (2002), wherein group life insurance policies were held to be “property” and therefore included in the computation of decedent’s augmented estate despite provisions limiting attachment or liens on such policies under Va. Code §38.2-3339.<sup>2</sup>
- b. In *Dowling v. Rowan*, 270 Va. 510, 621 S.E. 2d 397 (2005) Wilma Dowling transferred policies of insurance on her life irrevocable life insurance trust, which named her daughter as beneficiary of the trust. At the time of the transfer the policies had no cash value, as one was a term policy and the other was a “graded” whole life policy with no cash value until Wilma reached eighty (80) years of age.
- c. The Court in reviewing the requirements for inclusion of these policies into Wilma’s augmented estate, stated that a life insurance policy subject to the decedent’s control on the date of an irrevocable transfer is treated as “property” within the augmented estate statute. The Court also noted that property transferred to a third party donee within five (5) years prior to death will be included in the augmented estate to the extent that the transferred value exceeds Ten Thousand Dollars (\$10,000.00).
- d. Daniel Dowling urges the Court to recognize the “full proceeds of the existing policies” as the appropriate measured value.
- e. The Court declined to adopt Daniel’s position and declined to rewrite the plain meaning of the clear unequivocal terms of the statute. The Court found it self-evident that the value of a term life insurance policy upon transfer before death of the insured is not the full death benefit. Daniel had the burden of proof to seek inclusion of property in the augmented estate under *Chappell v. Perkins* (See below), and the only evidence of record offered was the annual premium of the policies in the year of transfer, totaling a sum far less than Ten Thousand Dollars (\$10,000.00). The Court ruled that Daniel Dowling failed to prove that the Ten Thousand Dollar (\$10,000.00) gift threshold was exceeded, causing a “pull-back” of the insurance policies into the decedent’s augmented estate.

6. **Burden of Proof.** The surviving spouse bears the burden of proof with respect to the

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<sup>2</sup> The issue of whether Va. Code §64.1-16.2 (allowing the judge to enter an order directing the method by which the liability to the surviving spouse shall be satisfied) is in conflict with the prohibition against “attachment, garnishment, or other process” and was not decided and remains an open issue (*Id.* at 234).

composition of the augmented estate and the allocation of liability. See, Gray, "Virginia's Augmented Estate System: An Overview: 24 U. Rich. L. Rev 513 (1990). Without the benefit of the presumption provided by the UPC on property owned by the surviving spouse, the burden of proof as to charges against the elective share is unclear.

- a. In *Chappell v. Perkins*, 266 Va. 413, 587 S.E. 2d 584 (2003), the Supreme Court of Virginia addressed the issue of burden of proof for the first (and only) time. Walter and Carole Perkins were married from 1988 until Carole's death in 1997. During their marriage Walter and Carole purchased property in Northampton County in 1989 as tenants by the entirety and in 1991 conveyed the property to Carole. In 1992 Walter and Carole built a residence on the property paid for with funds from the sale of other jointly owned property, funds contributed by both and by a loan secured by Carole's securities. Carole transferred the property into her revocable living trust prior to her death.

Noting that the augmented estate statutes are silent as to burdens of proof, the Virginia Supreme Court held that regardless of who files the complaint to determine the elective share, the party seeking the inclusion of property has the burden of proof and the party seeking exclusion of property carries the burden of establishing such exclusion.

## 7. **The Decedent's Net Probate Estate.**

- a. The net probate estate by definition includes those assets the surviving spouse received under the decedent's will or by intestacy.
- b. A surviving spouse claiming an elective share in the augmented estate is entitled to exempt property and a family allowance *in addition* to the elective share, but is not entitled to a homestead allowance. Va. Code §64.1-151.3.
- c. The omission of any reference to taxes in the original act caused concern that death taxes might be taken into consideration in computing the net probate estate, thus charging the spouse with a portion of these taxes and creating problems in computing the marital deduction for federal estate tax purposes. In 1992, the provisions of Va. Code §64.1-161 were amended to exclude federal or state transfer taxes from deduction as charges of administration and corrected the problems in determining the marital deduction caused by the original version of the act.
- d. *Matter of Estate of Smith*, 718 P. 2d 1069 (Colo. App. 1986), holds that expenses incurred by the personal representatives in *resisting* a forced share claim may not be taken into consideration in computing the net probate estate, as the contest over the elective share is essentially a contest among beneficiaries.

1. On the same theory, expenses of the surviving spouse in pursuing a forced share election are not expenses of the estate. *Tillman v. Smith*, 526 So. 2d 730 (Fla. App. 1988), while acknowledging this principal, allowed a portion of the surviving spouse's attorney fees as a charge against the estate to the extent attributable to tax advice and tax savings to the estate produced by the forced share election.
2. The Virginia statutes are silent as to the exclusion of the expense of determining the elective share from other deductible estate expenses.
3. Va. Code §26-30 provides that the Commissioner of accounts, in stating and settling the account, shall allow the fiduciary any reasonable expenses incurred.
4. In *Dowling v. Rowan*, 270 Va. 510, 621 S.E. 2d 297 (2005). The Supreme Court of Virginia denied the Executor and surviving spouse, Dowling, reimbursement of his legal expenses in pursuing his claim for his share of the augmented estate of his deceased wife. Noting that “reasonable expenses can be paid out of the estate when the fiduciary, in execution of his duties, proceeds in good and the aid of counsel is reasonably necessary for the performance of the fiduciary duties (See *Clare v. Grasty*, 213 Va. 165, 191 S.E. 2d 184 (1972)), the Court distinguished Dowling’s elective share claim from his duties as Executor. The Court held that “Dowling’s attempt to characterize his elective share litigation as ‘necessary’ to settle the estate confuses his function as Executor with his personal interests.” The Circuit Court’s denial of the claim for fee relating to the elective share litigation was deemed by the Supreme Court of Virginia to be proper.
5. The issue of expenses incurred by an Executor (other than the surviving spouse) in determining the elective share being deemed properly payable under Va. Code §26-30 remains unaddressed by statute or the Courts.

8. **Property the Surviving Spouse Derived from the Decedent.**

- a. This is essentially a gross-up provision to bring back gifts by the decedent to the surviving spouse and non-probate dispositions in favor of the surviving spouse, as the surviving spouse will be charged with these items in computing the elective share. The purpose is to prevent "double dipping" and balance the equities of the surviving spouse against other beneficiaries.
- b. The transfers to the surviving spouse brought in by this provision include transfers *prior to* the marriage as well as transfers *during* the marriage.

- c. There has been considerable discussion of the implication of the tangibles exclusion and the possibility for inequities in the case of transfers of tangibles of significant value such as jewelry or works of art. The exclusion of tangibles is not found in either the UPC or the RUPC.
  
- d. UPC §2-202(2)(ii) contains a broad list of examples of property considered to be "derived from" the decedent. The Virginia statute contains no such list.
  - 1. Among the items enumerated in UPC §2-202(2)(i) as being derived from the decedent are the surviving spouse's interest in a trust created by the decedent during his lifetime, a general or special power of appointment exercised in favor of the spouse to the extent it could have been exercised in favor of someone else, insurance on the decedent's life to the extent the decedent paid the premiums, annuity proceeds to the extent attributable to the decedent's contributions, retirement benefits, and the like. Premiums paid by the decedent's employer, partners, or a partnership of which he is a member are considered paid by the decedent.
  
  - 2. In the absence of a list of examples in the Virginia law, it may be advisable to consider that anything to which the surviving spouse becomes entitled by reason of the decedent's death is "derived from" the deceased spouse.
    - (1) Notwithstanding Virginia law that considers the donor of a power of appointment as the transferor, property passing to a spouse by exercise of a power of appointment by the decedent or by default that could have been appointed to persons other than the surviving spouse should be treated as "derived from" the decedent. *See*, Kurtz, "The Augmented Estate Concept Under the Uniform Probate Code: In Search of an Equitable Elective Share," 62 Iowa L Rev. 981, 1039 (1977).
      - (a) The RUPC expressly includes property passing to the spouse by reason of the exercise of a power of appointment as derived from the decedent, but excludes property passing to the spouse in default of the exercise of power held by the decedent. RUPC §2-202 (a)(2).
  
    - (2) It has been argued that appreciation in value of property that is derived from the decedent may also be considered derived from the decedent. Kurtz, *supra*, at 1042. Virginia law is silent on this point.

3. While property acquired jointly by the decedent and the surviving spouse should be considered "derived from" the decedent to the extent the decedent furnished consideration, property transferred to husband and wife jointly with survivorship by a third party should not be considered "derived from" either spouse. *See*, Emery, "The Utah Uniform Probate Code – Protection of the Surviving Spouse – The Elective Share" 4 Utah L. Rev. 771, 850 (1976).
4. Should exempt property and the family allowance be considered as derived from the decedent? The UPC and Virginia Code provide these items are available to the surviving spouse regardless of whether an elective share is claimed. *See*, UPC §2-206 and Va. Code §64.1-151 *et seq.* The RUPC specifically excludes the homestead and family allowance as well as exempt property from those items charged against the surviving spouse's share. RUPC §2-206.
- e. *Matter of Estate of Donahue*, 464 N.W. 2d 393 (S.D. 1990), holds that Veterans benefits and CHAMPUS benefits payable to a surviving spouse are part of the decedent's augmented estate, notwithstanding that the spouse's entitlement thereto is a matter of statute.
- f. The UPC includes a rebuttable presumption that property owned by the surviving spouse at the decedent's death is presumed to have been derived from the decedent. Virginia law has no comparable provision. *See*, Gray, *supra*, at 537.

9. **Contributions of the Surviving Spouse.**

- a. *Matter of Estate of Donahue*, *supra*, and *Estate of Fisher*, 545 A. 2d 1266 (Me. 1988), provide examples of how the surviving spouse's contributions to jointly owned property are calculated. The courts focus on the property the surviving spouse brought to the marriage, the income or lack thereof of the surviving spouse during marriage, and spending and saving patterns during marriage.
- b. *Estate of Leve v. Leve*, 704 S.W. 2d 263 (Mo. Ct. App. 1986), considers the issue of whether services as a homemaker can be considered as a contribution in money's worth of a deceased spouse. Wife predeceased husband, owning only property she had received from her family. She left a will leaving all of her property to her brother. With the exception of this property, all other property was jointly owned. Husband had been the only wage earner. Husband claimed an elective share and took the position that none of the joint property should be charged against him, as he paid for it. The court disagreed, finding that the homemaking services of the deceased spouse should be considered a contribution of "money's worth" to the jointly owned

property, and remanded the case for a determination of the value of the spouse's contribution.

1. The *Leve* rationale will deplete the augmented share which the wage earner spouse may claim by charging that spouse for the value of jointly owned property attributable to homemaking services. By the same token, it prevents this property from being charged against the homemaking spouse.
  2. It has been noted that in other contexts (i.e., divorce law), the services of the non-wage earning spouse are presumed to be of equal value to those of the wage earning spouse. *Note*: "Homemaking Services and the Elective Share: Out of the Kitchen and Into the Money," 52 Mo. L. Rev. 697 (1987).
- c. The RUPC avoids many of the issues of inter-spousal tracing and contribution by measuring the elective share on the basis of the *combined* augmented estate of both spouses. RUPC §2-202(b). Virginia law has not yet addressed this issue.

10. **Property Which Would Have Been Included in the Surviving Spouse's Augmented Estate.**

- a. This is essentially a protective provision to prevent the surviving spouse from reducing the gross-up and corresponding offset by lifetime transfers.
- b. Read literally, this provision initially included property derived from the decedent that the surviving spouse subsequently transferred, even though the surviving spouse had given the decedent full and adequate consideration. At that time, at least one commentator believed that the statute should be read to include only property transferred by the surviving spouse which was derived from the decedent *without* adequate consideration. Gray, *supra*, at 522. This appeared to be the proper interpretation as, in 1992, the statute was amended to include only property derived from the decedent without adequate consideration.
- c. The statute does not state the time as of which the surviving spouse is treated as having predeceased the decedent. One commentator has suggested the appropriate time is immediately before the decedent's death. Kurtz, *supra*, at 1037.

11. **Transfers to Third Parties other than Bona Fide Purchasers for Less Than Full and Adequate Consideration.**

- a. While similar to rules used in the case of spousal transfers, these rules operate completely independently of the spousal rules. Thus, for example,

the \$10,000.00 exemption does not apply to spousal transfers.

- b. The UPC and RUPC only bring in gifts made within two (2) years of the decedent's death. Under the Virginia statute, gifts, to the extent not otherwise excluded, are brought back into the augmented estate for the year of the decedent's death and any of the five (5) preceding calendar years.
- c. Joint bank accounts present special problems. It has been suggested that withdrawals by a third party account owner who did not contribute to the account be treated as gifts by the person providing funds in the account at the times of withdrawal. Kurtz, *supra*, at 1036.
- d. Note that the Ten Thousand Dollar (\$10,000.00) gift exemption, once equivalent to the annual gift tax exclusion found in IRC §2503, has not been indexed for inflation as provided in the federal tax code.

**12. Items Excluded from Computation of the Augmented Estate.**

- a. Property transferred by the decedent with the written consent or joinder of the surviving spouse. Va. Code §64.1-16.1.
- b. The value of any property received before or during marriage by the deceased spouse by gift, will or intestate succession or any other method or form of transfer from other than the surviving spouse, and the proceeds and income therefrom, to the extent such property, income or proceeds are maintained as separate property. Va. Code §64.1-16.1.
- c. Any transfer made to anyone other than the surviving spouse prior to January 1, 1991, to the extent irrevocable on January 1, 1991. Va. Code §64.1-13.
- d. Property received by deceased spouse by gift or inheritance or any other method or form of transfer before or during the marriage is excluded from the augmented estate only to the extent it is maintained as separate property during marriage.
  - 1. This exclusion is peculiar to Virginia and not found in the UPC or the RUPC.
  - 2. The exclusion only applies to property received both before and during the marriage, but only if maintained by the decedent as separate property.
  - 3. An extensive definition of separate property is found in Va. Code §20-107.3 dealing with equitable distribution. The history of this section before the courts and in the General Assembly indicates that commingling and possible contributions to the value of separate

property have been thorny issues.

4. The issue of “maintaining property as separate property” was discussed in the case *Dowling v. Rowan*, 270 Va. 510, 621 S.E. 2d 397 (2005). In this matter, the Supreme Court of Virginia was presented with some unusual facts, which led to a logical and well-reasoned answer.

a. At the time of her death, Wilma Dowling held a remainder interest in real property located in Peru that she acquired by intestate succession. Wilma and her husband, Daniel, had entered into a property agreement prior to their marriage, each agreed to treat property specified on a list attached to the agreement as “separate property”. Wilma’s spousal interest in the property in Peru was not listed in this agreement.

b. Daniel urged the Court to include the value of Wilma’s remainder interest as part of her augmented estate as she did not perform any physical repair or maintenance upon the property to consider it as “maintained as separate” under the statute.

c. The Supreme Court stating that they are “bound by the plain meaning of the words used unless a literal interpretation would result in a manifest absurdity” agreed with Daniel. The properties at issue were located in Peru and Wilma’s relatives, who held similar interests, occupied several of the properties. The Court felt that it would be “manifestly absurd” to require that Wilma travel to another country, to enter upon lands used or occupied by others, and perform physical improvements as an act of “maintenance” in order to maintain the property as her separate property under the augmented estate statutes.

d. The Supreme Court logically stated that the word “maintain” as used in Va. Code §64.1-16.1(B)(ii) does not refer to physical maintenance or the property, income of proceeds, but rather to keeping a legal interest in the property separate. As Daniel did not argue that Wilma took any action, such as co-mingling or re-titling the Peruvian remainder interest which would defeat its status as separate property, the Court concluded that Wilma’s interest in the Peruvian properties was maintained as separate and properly excluded the value of these properties from her augmented estate.

e. Pre-1991 Irrevocable Transfers.

1. Transfers to a surviving spouse prior to 1991 are not excluded.
2. Presumably pre-1991 transfers with a prohibited retained interest that are irrevocable will be protected. Gray, *supra*, at 253. Should a transfer with a right of invasion be considered irrevocable?

13. **Bona Fide Purchasers and Full and Adequate Consideration.**

- a. The full and adequate consideration and bona fide purchaser qualifications work independently of each other. Each is a ground for excluding property transferred to a non-spouse from the augmented estate.
  1. The bona fide purchaser exception is intended to preserve an arm's length transaction when the consideration might have been less than adequate. Emery, *supra*, at 789; Gray, *supra*, at 525.
  2. The statute contains no definition of a bona fide purchaser, a matter which has, in the past, caused serious concern to title insurance companies among others. *See* Va. Code §64.1-01.
    - (1) A three part test has been suggested by one commentator *See* Emery, *supra*, at 789:
      - (a) Was there less than adequate consideration?
      - (b) Was the transfer made while the transferor was married?
      - (c) Was it made under circumstances that indicate the testamentary characteristics of a transfer specifically included in the augmented estate?
    - (2) The UPC defines a bona fide purchaser as a purchaser for value in good faith without notice of any adverse claim. UPC §2-202(3). The payment of recording tax is considered *prima facie* evidence that the transfer was made to a bona fide purchaser.
    - (3) The Virginia law of fraudulent conveyances provides that a bona fide purchaser is one who gives consideration without actual or constructive notice of fraud. Gray, *supra*, at 526. Va. Code §55-80.
    - (4) Other Virginia statutes combine the concepts of valuable consideration, notice and good faith to protect bona fide

purchasers. See Va. Code §§8.2-403; 55-96; 64.1-95, 64.1-96; 64.1-113.

- (5) VA. Code §64.1-01 was included in 1992 to address these concerns. It provides that:

As used in this title, "bona fide purchaser" means a purchaser of property for value who has acted in the transaction in good faith. Notice of a seller's marital status, or notice of the existence of a premarital or marital agreement, does not affect the status of a bona fide purchaser. A "purchaser" is one who acquires property by sale, lease, discount, negotiation, mortgage, pledge, or lien or who otherwise deals with property in a voluntary transaction, other than a gift. A purchaser gives "value" for property acquired in return for a binding commitment to extend credit to the transferor or another as security for or in total or partial satisfaction of a pre-existing claim, or in return for any other consideration sufficient to support a simple contract.

- b. There is a question as to what constitutes full and adequate consideration in the case of a transfer by the decedent with a retained life interest or powers of invasion for his own benefit.
1. Does the reference to Va. Code §55-269.1 for valuation purposes imply that payment of consideration equal to the value of the transferred interest under that Section constitutes full and adequate consideration?
  2. On the other hand, the provision of the statute requiring valuation as of the date of death unless the transferee comes into possession or enjoyment prior to death would support the conclusion that the full value of the transferred property should be used for measuring adequate consideration.
  3. Note that there is support for the proposition that adequate consideration for tax purposes refers to the value of the entire property, not just the transferred interest. *Gradow v. United States*, 897 F. 2d 516 (Fed. Cir. 1990). (*But See Wheeler v. U.S.* 116 F.3d. 749 (5<sup>th</sup> Cir. Tex. 1997).
- c. Property is brought back into the augmented estate "to the extent" the consideration is less than full and adequate, thus giving the transferee credit

for his contribution.

- d. Will transfers by the decedent in satisfaction of a support obligation to a child be considered for full and adequate consideration? Should spouses be treated differently than other individuals? There is no clear guidance in Virginia law on these issues.

14. **Valuation.** For purposes of computing the size of the augmented estate, property is valued at the decedent's death, except that property irrevocably transferred by the decedent during his lifetime is valued as of the earlier of the decedent's death or the date the transferee came into possession and enjoyment of the property. Life estates and remainders are valued under the provisions of Va. Code §55-269.1 *et seq.* Terms of years and deferred payments are discounted to present value using the interest rate specified in Va. Code §55-269.1. Va. Code §64.1-16.1.

- a. The Virginia valuation provisions follow the provisions of the UPC with respect to transfers to third parties. The UPC, however, provides a different rule for spousal transfers and values them as of the date of an irrevocable transfer or the decedent's death, whichever occurs first.
- b. The focus on possession or enjoyment eliminates the determination of when the right vests.
- c. While the overlap between gifts and transfers with retained interests or powers may reduce the need for categorization to determine whether a transfer is included in the augmented estate, it will be important in determining how the property is valued.

15. **Property Transferred During Lifetime but Valued as the Date of Death Poses Potential Problems.**

- a. How are improvements to the property to be treated? It has been argued that the property should be revalued immediately before the improvement and that a fraction based on the added value be derived to separate appreciation in value due to the improvement and appreciation attributable to the initial transfer. Kurtz, *supra*, at 1035.
- b. Partial consideration is another difficult issue. Should the actual amount of the consideration be applied against the date of death value, or should the consideration be adjusted to reflect appreciation or depreciation occurring between the date of transfer and the date of death? Kurtz, *supra*, at 1020.

16. Traditional estate tax valuation concepts, such as blockage discounts, have been recognized by other jurisdictions in valuing the augmented estate. *Williams v. Harrington*, 460 S. 2d 533 (Fla. App. 1984). In *Matter of Estate of Donahue*, *supra*,

the court looked to applicable provisions of federal estate and gift tax law to value annuities and CHAMPUS benefits. Minority discounts have been considered for fractional interests conveyed in satisfaction of a spouse's claim in at least one lower court decision in Virginia. *See, Estate of Smith*, 69 Va. Cir. 259 (2005).

17. The UPC provides that life estates are presumed to be worth half of the total value of property unless a higher or lower value is established. UPC §2-207(a). This may provide some flexibility not found in Virginia's use of the procedures in Va. Code §55-269.1 *et seq.*
18. The elective share is a pecuniary amount, not a fractional share. Its value is fixed as of a date not later than the decedent's death. While interest is credited on the elective share at the legal rate, the elective share does not otherwise share in income, gains or losses of the estate.
  - a. This is a change in Virginia law as reflected in *Alexandria National Bank v. Thomas*, 213 Va. 620, 194 S.E. 2d 723 (1973).
  - b. One court has refused to apply the equitable adjustment doctrine to a distribution of an elective share amount which was treated as carrying out a substantial amount of DNI for tax purposes. The court found that the pecuniary language of the statute left no room for equitable adjustments. *Williams v. Harrington, supra.*
  - c. Neither the UPC nor the RUPC provide for interest on the elective share.
  - d. On what amount does interest run? While the statute is unclear, it should only be interpreted as providing for interest on the *net amount due*, if any, after all credits on behalf of the surviving spouse.
19. Property which passes on to the surviving spouse is credited against the elective share. The remaining liability is equitably apportioned among the recipients of the augmented estate in proportion to the value of their interests therein.
  - a. Not specifically recognized are transfers by the surviving spouse of property received from the decedent. It has been suggested that those transfers should be treated as a direct credit against the elective share just as if the spouse had retained the property and that the transferees of the spouse should not be required to contribute to the augmented estate. *Kurtz, supra*, at 1047.
  - b. There is no clear indication as to whether the "recipient" of a transfer in trust is the trustee or the beneficiary, how a spendthrift clause may affect a trust's liability for the elective share, or whether the elective share claim should be charged to income or principal. *Kurtz, supra*, at 1048. It seems appropriate to treat the trustee as the recipient and only include beneficiaries to the extent they have received *principal* from the trust. It would also seem appropriate

to charge the liability to principal, and to ignore the spendthrift provision as it applies to the interests of the beneficiaries in the trust, not to the corpus of the trust or trust property in the possession of the beneficiaries.

- c. Virginia appears to change the UPC rule on the liability of transferees from the decedent to contribute to the augmented estate. Should transferees with respect to which there is no possibility of recovery be brought into the calculation of the augmented estate and allocation of the liability? Doing so may increase the surviving spouse's share. Gray, *supra*, at 535. It may also make a material difference in the case of the transferees of the surviving spouse. There are strong policy reasons for including these persons in the augmented estate and charging the elective share with these transfers even though the transferees may no longer have the property. Holding to the contrary could allow the surviving spouse's transferees to manipulate the size of the elective share and the liability of third parties.
  - d. Transferees and donees from the decedent and persons receiving the property from them by gift or inheritance are liable to contribute to the augmented estate to the extent they have the property or its proceeds.
    1. The term "proceeds" is not defined in the statute.
    2. The Uniform Commercial Code defines the term "proceeds" as including "whatever is received on the sale, exchange, collection or other disposition of collateral or proceeds." Insurance not paid to a third party is expressly included. Va. Code §8.9-306(1).
20. As noted above, the UPC contemplates a procedure initiated by the surviving spouse and essentially in control of the surviving spouse. The surviving spouse has the burden of giving notice to those persons interested in the augmented estate. The UPC also provides that the surviving spouse may withdraw an elective share claim any time before a final order of the court. The UPC also provides that the proceeding may be maintained against fewer than all persons against whom relief could be sought, but a contributor's liability may not be increased by the omission of a potential contributor.
21. Virginia's provisions on contribution parallel the UPC, but with significant differences.
- a. Virginia has no provision allowing the withdrawal of an election.
  - b. While the spouse must make the initial claim under Virginia law, the statute contemplates that the spouse, the decedent's personal representative, or any person in interest can bring a petition to determine the elective share.
  - c. The litigation expenses of the surviving spouse or any interested parties are

personal expenses, not reimbursable from the estate. *See Dowling v. Rowan*, 270 Va. 510, 621 S.E. 2d. 397 (2005). What of the expenses incurred by the Executor in determining the elective share? Va. Code §26-30 may control in such a situation. The court in *Dowling*, seemed to approve the payment of an Executor's fees in maintaining or participating in litigation if done in the execution of his duties or administration. *See Dowling, supra*, at 403.

- d. The surviving spouse may lose control of the litigation if he or she does not file an appropriate petition quickly.
  - e. The statute contemplates that persons may be omitted from the petition without increasing the liability of other potential contributors. The statute's recognition that parties may be deliberately omitted should supersede traditional equity concepts of "necessary parties" and prevent persons not named in the original petition as being named as additional defendants on the motion of other defendants. Should the petitioner be allowed to add additional parties?
22. The provision of the augmented estate statute apportioning liability among recipients of the augment estate would appear to change existing Virginia law on how gifts abate to satisfy an elective share claim.
- a. Under prior law, an elective share claim was satisfied first from assets passing as part of the residuary estate, and only after these assets were exhausted was it apportioned against other gifts. *Morriss v. Garland's Adm'r.*, 78 Va. 215 (1883); *Denny v. Searles*, 150 Va. 701, 143 S.E. 484 (1928).
  - b. The requirement of the statute that all recipients contribute in proportion to the property received would appear to require that all gifts under the will abate ratably.
  - c. After charging the elective share for spousal property, the RUPC provides that liability for the balance of the elective share is charged first against the probate estate, then against outright gifts, and finally against all other transfers. RUPC §2-207. Virginia has not adopted this provision of the revised Code.
23. Given the mechanical and mathematical nature of the computation of the elective share, can a spouse withdraw a forced share claim or omit a potential contributor from a forced share claim without the possibility of making a gift to the potential contributor(s)? *See Rev. Rul. 84-105*, 84-2 C.B. 197, which holds that a spouse's failure to contest an under-funded formula marital deduction transfer results in a gift as of the date the under-funding can no longer be challenged. *See also Rev. Rul. 81-624*, 81-2 C.B. 186, which holds a gift arises when statute of limitations is allowed to

run on a loan to a solvent family member, and Rev. Rul. 79-225, 79-2 C.B. 345, which finds a gift when a division of property is made between a life tenant and remainderman which does not reflect their actuarial interests.

#### IV. SATISFACTION

1. Satisfaction of elective share liability in cash or a portion of the augmented estate property equal to the liability, or the total property if its value is less, does not require the consent of the surviving spouse. A conveyance of property not included in the decedent's augmented estate requires the consent of the surviving spouse.
  - a. If the circumstances indicate it is appropriate, can a different valuation approach be taken in valuation of property for determining the value of property for the size of the elective share and how much of that property is to be used in satisfying the elective share? *Williams v. Harrington, supra*, held that a personal representative was not equitably required to use the same blockage discount in each instance. The Supreme Court of Virginia has not addressed this issue by decision, nor has the General Assembly proposed statutory guidance. *See, however, Estate of Smith*, 69 Va. Cir. 259 (2005) regarding the transfer of fractional interests.
  - b. The elective share and interest thereon is satisfied and charged against recipients of the augmented estate as follows:
    1. The elective share is satisfied first from the augmented estate property which passes or has passed to the surviving spouse, including any property disclaimed by the spouse. Va. Code §64.1-16.2(A).
    2. Any balance remaining after charging the spouse for property received from the decedent is equitably apportioned among the recipients of augmented estate property in proportion to the value of their interests therein. Va. Code §64.1-16.2(B).
  - c. Under the UPC, the decedent's transferees are personally liable for contribution to the augmented estate, even though they no longer have the property. UPC §2-207(c). Donees of the original transferees are only liable to the extent the donees have the property or it proceeds. Virginia law may be read in such a way as to protect original transferees who do not have the property or its proceeds as well as subsequent donees. Va. Code §64.1-16.2(C). If Virginia law is interpreted in this fashion, the following questions arise:
    1. The statute would appear to require the augmented estate to be computed without regard to whether the claim is unenforceable against a recipient. Are unenforceable claims excluded when computing the shares of the liability of recipients for contribution?

2. How is the \$10,000.00 exclusion to be allocated among gifts that the original transferee retains and gifts the original transferee has consumed or transferred?
- d. Commentators have suggested that tax concepts may be applicable in determining the number of donees in a particular transaction. A transfer in trust with the direction to pay income to C and D with remainder to A and B should be treated as a transfer to four separate donees. Kurtz, *supra*, at 1033.
- e. Only the original transferees of property from the decedent and any subsequent gratuitous *inter vivos* transferees or transferees by will or intestacy are liable to contribute, and then only to the extent they have the property or its proceeds. Va. Code §64.1-16.2(C). In May 1992, the General Assembly also imposed liability for contribution to fiduciaries who have received notice of the claim for the elective share in the decedent's estate.
- f. The decedent's spouse, the decedent's personal representative, or any party in interest can ask the court to determine the share of the surviving spouse and the liability of each interested party to contribute. Va. Code §64.1-16.2(D).
  1. The proceeding does not have to include all those who may be liable for the augmented estate, but no contributor's liability may be increased by the omission of a potential contributor. Va. Code §64.1-16.2(D).
  2. Within thirty (30) days of the date the court's determination becomes final, each person liable for contribution may file with the court a written statement specifying any one of the following methods to satisfy his liability. Va. Code §64.1-16.2(E).
    - (1) Payment in cash, or other property to which the surviving spouse agrees.
    - (2) Conveyance of a portion of the property included in the augmented estate to the extent of his liability. If the value of the property is less than his liability on the date the contribution statement is filed, that property may be conveyed in its entirety to the spouse in full satisfaction of his obligation.
    - (3) A combination of (1) and (2), provided the value conveyed and paid equals the liability.
  3. In the event a person liable for contribution does not file the

necessary statement within thirty (30) days, the Court will enter an order specifying in which of these three ways the liability to the surviving spouse will be satisfied. Va. Code §64.1-16.2(E).

4. Interest at the legal rate runs on the elective share from the date of death of the deceased spouse until the date the elective share is satisfied. Va. Code §64.1-16. Currently, the legal rate of interest is six percent (6%) under Va. Code §6.1-330.53.

## V. PROTECTION (DEFENSES)

### 1. Waivers.

- a. Both the UPC and the RUPC recognize that a spouse may waive his or her right to an elective share of the augmented estate and set forth standards the waiver must satisfy to be enforceable.
- b. Comparable provisions under Virginia law are found in Va. Code §20-147 *et seq.* with respect to pre-marital agreements. Va. Code §20-155 extends the same concepts to agreements made after marriage.
- c. At least one court has held that a marital agreement entered into before the enactment of augmented estate legislation was sufficient to waive all rights to an elective share of an augmented estate against a claim that the waiver should not be effective as to rights that were not in existence on the date of the agreement. The court found that the augmented estate provisions were not intended to be retroactive and upheld the waiver as to augmented estate claims. *In Re Matter of Estate of Abbott*, 39 Colo. App. 536, 571 P. 2d 311 (Col. App. 1977). This case also provides an example of a specific waiver or joinder as to a particular will that may be helpful in cases when a general waiver is not appropriate.
- d. On the other hand, a simple agreement that spouses will treat their property as "separate" without any reference as to what happens at death will probably not be sufficient to waive rights to a forced share. *Estate of Berzinis*, 505 A.2d 86 (Me. 1986).
- e. *Pysell v. Keck*, 263 Va. 457, 559 S.E. 2d 677 (2002), the Supreme Court of Virginia was presented the opportunity to consider the scope of an antenuptial agreement as a defense to the augmented estate claim.
  1. Prior to marriage Debra Pysell and David Pysell entered into a one (1) page antenuptial agreement which provided, in part, that each would own "as his or her separate property, all of the real, personal or mixed property which they individually own as of this date". The agreement also went on to state that the parties "may hereafter

individually acquire additional property of a similar nature, and it is the intention of the parties hereto that said property shall also be the individual property of the person acquiring the same.” (*Id.* at 459). The agreement recited that the parties rights to each other’s property acquired by operation of law be solely determined and fixed by the agreement.

2. David died and his will made no provisions for Debra. Debra filed a claim for her elective share under Va. Code §64.1-13, and a claim for both the Family Allowance and Exempt Property Allowance.
3. The Executor filed a declaratory judgment action alleging two (2) grounds of defense to Debra’s claims: (1) abandonment and desertion and (2) waiver of the claims by reason of the antenuptial agreement. Later the Executor filed a motion for summary judgment based solely on the second ground, waiver by agreement.
4. Debra maintained that the agreement to hold individual property separate, and the intent that the rights to each other’s property be solely determined by the agreement did not constitute a waiver of her rights to David’s estate. The trial court held that the agreement was an effective waiver of the wife’s rights to the husband’s estate upon his death and Debra appealed.
5. The Supreme Court resolved the disagreement by applying the rules of construction applicable to contracts generally, including the plain meaning of unambiguous contractual terms. The Court found nothing in the language of the agreement that did anything more than expressing the intention to hold as separate property the property owned individually by each at the time of the marriage or acquired thereafter as separate property. As the Court stated:

No waiver in these three paragraphs or elsewhere in the agreement do we find a reference to either party’s rights in the property of the estate of the other. In other words, the only marital rights determined and fixed by the agreement were those of the husband and wife while they were living. (*Id.* at 460-461)

Reading the “plain language of the agreement,” the majority refused the executor’s construction of the agreement as requiring an unwarranted addition to the plain meaning of the agreement’s language, and remanded the case to the trial court for further proceedings.

6. The dissent, while noting that the agreement was executed “without

express reference to the death of each spouse as specifically addressed in the Va. Code §20-150(3) and raised by implication in Va. Code §20-150(5)” (*Id.* at 463), focused on the provision in the agreement that the agreement is the sole determination of the property rights of the husband and wife, and thus would be the bar to the surviving spouse’s claims.

2. The surviving spouse's elective share is absolutely barred by willful desertion or abandonment of the decedent, if the desertion or abandonment continued unabated to the date of the decedent's death. Va. Code §64.1-16.3. This is a carryover from prior Virginia law regarding renunciation of the decedent's will.
  - (a) The Supreme Court of Virginia recently had the opportunity to determine what constituted abandonment in defense to the augmented estate claim. In the case *Purce v. Patterson*, 275 Va. 190, 654 S.E. 2d 885 (2008).
  - (b) Marrill and Dorothy Purce had a tumultuous marriage. Dorothy had obtained a protective order against Marrill in 1997. In June 1998, when the protective order expired, Dorothy resumed co-habitation with Marrill. She sought additional protective orders that were later denied, claiming among other things that Marrill’s girlfriend was harassing her, and Marrill was drinking and staying out late every night.
  - (c) In June 2000, Dorothy and Marrill agreed that Dorothy would leave the marital residence. In 2003, Dorothy filed for a divorce identifying the grounds for the divorce as living separate and apart for more than one (1) year. The divorce decree was never issued and the parties remained legally married at the time of Dorothy’s death. During Dorothy’s last illness, Dorothy lived with her daughter in New Jersey and Marrill did not know Dorothy was in New Jersey nor did he visit, call or otherwise communicate with her. When Dorothy died, Marrill made a claim for his elective share of Dorothy’s property.
  - (d) The Circuit Court found that Marrill had abandoned his wife, and he appealed to the Supreme Court of Virginia arguing that post separation conduct is not relevant to whether one spouse abandoned the other.

In reading Va. Code §64.1-16.3(A), the Supreme Court noted that the clear language of the Code “requires a Court to determine whether the willful desertion or abandonment continued “until the death of the spouse” and that the determination is not limited to consideration of actions occurring prior to a separation, should one have occurred.”

The Court also noted that the term “abandonment” is not defined in the statutes governing elective share claims. The Court agreed that principals developed in domestic relations law relating to abandonment are helpful in determining the issue

of abandonment under Va. Code §64.1-16.3. Noting that abandonment is generally used synonymously with a desertion, the Court defined abandonment to mean “a termination of the normal indicia of a marital relationship combined with an intent to abandon the marital relationship.” The Court also found that while an agreed separation or petition for divorce is relevant evidence of the termination of co-habitation, it is not evidence which defeats a finding of willful abandonment, and that relevant evidence is the surviving spouse’s conduct and his or her intent.

3. Failure to make the forced share election within six (6) months from the decedent's death or the extended election period, as provided by Va. Code §§64.1-13 and 64.1-14, is a bar to the satisfaction of a late election.
4. If the surviving spouse makes the homestead election under §64.1-151.3, the augmented estate election will be precluded.

## **VI. ISSUES CONCERNING CURRENT VIRGINIA LAW**

1. The UPC expressly provides that the right of election is personal to the surviving spouse. While the Virginia statute does not contain a similar provision, case law prior to the enactment of the augmented estate provision held that a spouse's right of renunciation was personal to the spouse. *First National Exchange Bank v. Hughson*, 194 Va. 736, S.E. 2d 797 (1953). Although it seems reasonable to assume that *Hughson* is still good law absent some legislative action, this author is aware of several occasions where a circuit court has refused to limit the election to the surviving spouse, and has allowed an election by an agent under a durable power of attorney. (See page 4 of this outline). See, Gray, "Virginia's Augmented Estate System: An Overview," 24 U. Rich. L. Rev. 513, at 538-539 (1990).
  - a. As the right of election is a personal right, some courts have taken the position that if the surviving spouse dies after making the election but before the elective share is satisfied, the right to the elective share is forfeited. Emery, “The Utah Uniform Probate Code – Protection of the Surviving Spouse – The Elective Share,” 4 Utah L.Rev. 771 at 784 (1976). See the following cases upholding this position in the case of personal rights of homestead and family allowances and exempt property: *In Re Estate of Jackson*, 204 Nev. 180, 281 N.W. 2d 552 (1979), *Cf. Matter of Estate of Merkel*, 618 P. 2d 872 (Mont. 1980).
  - b. On the other hand, there is authority that the spouse need only survive to make the election itself. *Smail v. Hutchins*, 491 So. 2d 301 (Fla. App. 1986).
  - c. Requiring that the surviving spouse live until the share is satisfied will likely cause the elective share to be treated as a terminable interest for federal estate tax purposes, thus disqualifying it for the marital deduction.

- d. The RUPC provides that the spouse must be living at the time the election is made, at least implying that the spouse does not forfeit the share by dying afterwards. It also expressly allows the election to be made by a conservator, guardian or attorney-in-fact, but in such instances creates a trust wherein the remainder interest is retained by the decedent's estate. Virginia law does not expressly allow the election for the augmented estate to be made for the surviving spouse by agency.
  - e. A more prudent course of action may be for the surviving spouse to initiate a proceeding to determine the composition or value of the augmented estate shortly after the decedent's death and request a timely extension of the time to file an election. This would appear to leave the surviving spouse in complete control of the proceeding without filing the election and initiating an adversary proceeding.
2. Virginia's augmented estate laws focus on the property of the first spouse to die, rather than the combined assets of the marriage, as would be the case in a true economic partnership model.
- a. Consider the situation in which H and W have enjoyed a long and fruitful marital union. Their combined assets equal One Million Dollars (\$1,000,000.00). How the elective share is determined depends on how those assets are titled.
    - 1. For example, if H dies first and 20% of the assets are titled in H's name, W's ultimate share of the partnership assets will be as follows:
 

|                     |                  |
|---------------------|------------------|
| W's separate assets | \$800,000        |
| 1/3 of H's assets   | <u>\$ 66,667</u> |
|                     | \$866,677        |
    - 2. Under the same scenario, if W dies first, H's assets will be as follows:
 

|                     |                  |
|---------------------|------------------|
| H's separate assets | \$200,000        |
| 1/3 of W's assets   | <u>\$266,667</u> |
|                     | \$466,677        |
    - 3. Even at 50/50 titling of assets, the surviving spouse will possess more of the assets than the estate of the deceased spouse.
  - b. In shorter term marriages, especially those later in life, when other considerations may be paramount, the augmented estate rules currently in effect in Virginia reward the children of the surviving spouse, to the detriment of the children of the deceased spouse.

- c. Due to the “one size fits all” approach of Va. Code §64.1-13 *et. seq.* Virginia’s augmented estate laws more closely resemble a “support” based theory rather than an “economic partnership theory”.
  - d. It may be more advantageous, from a property standpoint, for the estate of the spouse first to die, for that spouse while living, to institute a divorce action, with equitable distribution of the marital assets, rather than die owning less than a majority of the assets.
3. OTHER ISSUES<sup>3</sup>
4. General Power of Appointment Held by Decedent and Created by Third Party.
- a. Does it fall under Va. Code 64.1-16.1?
    - (a) under Va. Code §64.1-16.1 (A) and (A)(3)(b): “estate passing by testate or intestate succession” plus “any transfer to the extent that the decedent retained for his life ... or for any period which does not in fact end before his death, a power... to dispose of the principal for his own benefit”
    - (b) but, exception under Va. Code §64.1-16.1(B)(ii): for “any property.... received by the decedent by gift, will... or any other method... before or during the marriage to the surviving spouse from someone other than the surviving spouse to the extent such property....maintained by the decedent as separate property”
    - (c) can an argument be made that the property was not maintained as “separate property”?
    - (d) what about creditor’s rights established under Virginia law that property subject to a general power of appointment that is exercised by the decedent is deemed in equity a part of the decedent’s assets and subject to the demands of the decedent’s creditors in preference to the claims of the decedent’s voluntary appointees or legatees? *See, Freeman v. Butters*, 94 Va. 406, 411, 26 S.E. 845 (1897), *quoting Brandies v. Cochrane*, 112 U.S. 344, 352 (1884). Can the surviving spouse also be considered a creditor for purposes of the elective share statute and argue to bring the assets over which the decedent had and exercised a general power of appointment to someone other than the surviving spouse into the augmented estate?
    - (e) what if exercised in favor of the surviving spouse? should the value of what the surviving spouse received be considered “derived from

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<sup>3</sup> This information was included in the outline “The Augmented Estate in Virginia” by Laura O. Pomeroy, presented at the 22<sup>nd</sup> Advanced Estate Planning and Administration Seminar. The author thanks Ms. Pomeroy for her contributions and permission to reproduce these matters.

the decedent” and charged against the spouse’s elective share? There is no definition of “derived from the decedent” under the Virginia statute, but see the pre-1990 UPC definition which includes such property. Further, Va. Code §64.1-16.2(C) refers to appointees being liable to make-up with elective share so, by inference, it would seem that the surviving spouse should be charged with any assets she or he receives from the decedent by his or her exercise of a power of appointment.

(f) what if exercisable during life? Both life and death? Only exercisable at death? *See* RUPC §2-205 on the inclusion or exclusion of property subject to a general power of appointment. The pre-1990 UPC is silent on how property subject to a general power of appointment is handled.

5. Tangible Personal Property Gifted by Decedent During Lifetime to Spouse – Always Excluded? What if Jointly Titled Tangible Personal Property?

a. Is the tangible personal property (or its proceeds) excluded under Va. Code §64.1-16.1(A)(1) and (2) because it was received by the surviving spouse by gift?

b. Consider whether the gifts allegedly made by the decedent satisfy the requirements of Va. Code §55-3. Unless there is a deed of gift for the tangibles (or proceeds) at issue, if the decedent and surviving spouse lived together at the time of the alleged gift and the tangible personal property is not considered to be “personal paraphernalia used exclusively by the donee”, then the gift would not have been valid under Virginia law. Because no gift was made, the tangible personal property (or proceeds) should be included in the decedent’s augmented estate.

c. In *Teed v. Powell*, 236 Va. 36, 39, 372 S.E. 2d 131 (1988), the Virginia Supreme Court held that the term “paraphernalia” as used in §55-3 meant “personal belongings, especially articles of adornment or attire, trappings; also the article that compose an apparatus, outfit or equipment; ... appointments or appurtenances in general.” The Court held in *Teed* that a rifle and three shotguns were not paraphernalia.

d. What if the tangible personal property is titled jointly with the surviving spouse at the time of the decedent’s death such as a car or boat? If the decedent paid 100% for the property, can the surviving spouse argue that ½ of the tangible personal property is excluded from the augmented estate based on the exclusion for tangible personal property received by gift? Or is the gift not considered to have been completed until death?

6. Transfer of Assets by Decedent to Decedent’s Revocable Trust Done Before Marriage.

a. Va. Code § 64.1-16.1 (A)(3) which contains the list of values of those properties transferred by the decedent that must be included in the augmented estate, limits inclusion to those transfers made by the decedent during the marriage.

b. If the decedent transfers all of his property prior to the marriage to a revocable trust, under the technical language of the Virginia statute, the property held in the revocable trust at the time of the decedent's death is not included in the augmented estate even though the decedent retained the right to revoke the trust, remain a beneficiary, and change the beneficiaries of the trust.

c. One Commentator states that the reason for this exclusion is that "generally speaking, the augmented estate law is not concerned with gifts of any property or any amount that are made to anyone (other than to one who later becomes the surviving spouse) prior to the marriage in question." See J. Rodney Johnson, "The Augmented Estate & Spousal Property Rights at Death," A Virginia Handbook, p. 18, fn. 37.

d. The pre-1990 UPC official comment specifically provides that the restriction to transfers during the marriage "makes it possible for a person to provide for children by a prior marriage, as by a revocable living trust, without concern that such provisions will be upset by later marriage." UPC Comment to Section 2-202.

e. One commentator raised the question whether property transferred just prior to the marriage (i.e. on the eve of the wedding) or at some time after the parties met and when it was clear the relationship was headed toward marriage but when the parties were not yet legally married, should be included in the augmented estate because of the confidential relationship existing between the parties at the time of the transfer. See J. Rodney Johnson, "The Augmented Estate & Spousal Property Rights at Death," A Virginia Handbook, p. 18, fn. 37.

f. One Virginia Circuit Court Judge has determined that a designation of a beneficiary on a life insurance policy before marriage is not sufficient to be deemed a "transfer" by the decedent before marriage. See, *Felix-Aranibar v. Felix*, 59 Va. Cir. 357 (2002).

#### 7. Conveyance of Summer Home to Child Outright But Continued Use by Decedent Until Date of Death.

a. During the marriage to surviving spouse, decedent transfers his summer home in fee simple to his son by a prior marriage over ten years before his death.

b. Decedent continues to use the summer home in the same amount or slightly less than before and child also uses home.

c. Does this fall under the augmented estate definition? It is not a transfer within six (6) years of death so it does not fall under Va. Code §64.1-16.1(A)(3)(d). Is it a transfer, however, where decedent retained for his life the "possession or enjoyment of" the property as contemplated by Va. Code §64.1-16.1(A)(3)(a)? Under IRC §2036, courts have often inferred that a parent's continued occupancy was intended from the outset and that such retained life use was subject to IRC § 2036(a). There are a number of cases involving IRC §2036(a) and implied agreements. See, for example, *Estate of Reichardt v. Commissioner*, 114 T.C. 144 (2000). It did not change the result that the decedent did not have a legal right to

enforce his or her possession. Also, Virginia recognizes oral trusts of real estate and, therefore, any oral understanding regarding real estate could be enforceable. *Gibbens v. Hardin*, 239 Va. 425, 389 S.E. 2d 478 (1990).

8. Assets in Joint Account Where Contributions Other Than By Decedent.

a. Va. Code §64.1-16.1(A)(3) relates to transfers by the decedent made during the marriage. If the assets of a joint account were not contributed 100% by the decedent or where only contributed in part by the decedent, only the property contributed by the decedent should be added to the augmented estate.

b. Note the valuation rules in Va. Code §64.1-16.1(C)(3) for determining the amount of the transfer made by the decedent to include in the value of the augmented estate. There is a rebuttable presumption that joint accounts between husband and wife were contributed to one-half by each.

9. Transfer of Transplanted Community Property By Decedent.

a. Va. Code §64.1-199 makes it clear that the decedent's one-half interest in transplanted community property is not subject to the surviving spouse's right to an elective share under Va. Code §64.1-13.

b. Presumably the language of Va. Code §64.1-199 restricts from inclusion in the augmented estate a transfer by the decedent during the marriage of his or her interest in any community property even if it falls under one of the restricted transfer provisions.

c. It is unclear, however, whether the decedent's interest in transplanted community property that passes to the surviving spouse or is gifted to the surviving spouse can be included in the augmented estate under either Va. Code §64.1-16.1(A)(1) or (2) or charged to the surviving spouse under Va. Code §64.1-16.2. *But see* Section 2-202 of the UPC which defines "derived from decedent" as including the community property passing to the surviving spouse from the decedent.

d. Virginia law will apply to property acquired by spouses who moved from a community property state to Virginia but only for property acquired *after* the move to Virginia while the laws of the community property state where the spouses moved from will continue to control the rights of the spouses to the community property acquired during their domicile in that state and any proceeds or income of that property or traceable to that property.

10. Spouse's Signature on Gift Tax Return Agreeing to Split the Gift to Child or on Income Tax Return Where Charitable Deduction Taken for Gift to Charity: Is this Sufficient Consent to Waive Inclusion in Augmented Estate?

a. Va. Code §64.1-16.1(B)(i) excludes the value of any property transferred by the decedent during marriage with the written consent or joinder of the surviving spouse.

b. It is unclear whether a surviving spouse's signature on a gift tax return agreeing to split a gift made by the decedent during the marriage is sufficient to meet the requirement of "written consent or joinder of the surviving spouse."

c. It is unclear whether a surviving spouse's signature on an income tax return where a charitable deduction is taken for a gift to charity made by the decedent during the marriage is sufficient to meet the requirement of "written consent or joinder of the surviving spouse."

d. One commentator notes that "it is quite consistent for a spouse who adamantly opposed the making of a particular gift to agree, after the gift is made, to sign a tax form in order to get the best tax result for the family unit." See J. Rodney Johnson, "The Augmented Estate & Spousal Property Rights at Death", A Virginia Handbook, p. 23, fn. 53.

e. Under the RUPC, the Comment to §2-208 states that spousal consent to split gift treatment under IRC §2513 is *not* written joinder or consent of the spouse. See Article II, Part 2, RUPC, Comment to §2-208, p. 121.

f. Under the RUPC, any spousal waiver that complies with ERISA would serve to exclude the value of the death benefits from the decedent's nonprobate transfers to others. See Article II, Part 2 of RUPC, Comment to §2-208, p. 122.

11. How is a Surviving Spouse's Interest in a QTIP Trust Valued for Purposes of Charging such Interest Against the Surviving Spouse's Elective Share?

a. Va. Code §64.1-16.2A states that in satisfying the elective share of the surviving spouse, "the values included in the augmented estate which pass or have passed to the surviving spouse..." are used first before any contributions are due from other recipients of transfers included in the augmented estate.

b. Under Va. Code §64.1-16.1, the entire value of the QTIP trust is included in the augmented estate. Does this mean that because the QTIP trust passes to the surviving spouse for her lifetime, with remainder to decedent husband's children from a prior marriage she is charged with the *entire* value of the QTIP trust because the entire value of the QTIP trust was included in the augmented estate?

c. Va. Code §64.1-16.1 provides for the valuation of life estates and remainder interests as prescribed in Va. Code §55-269.1 but does not refer to Va. Code §55-269.1 for valuing an income interest in a lifetime trust (such as a QTIP trust) or an income interest in a trust combined with discretionary distributions of principal.

d. In *In re: Estate of Robert DeShazo*, Arlington County Circuit Court, Chancery No. 96-488 (unreported decision, Feb. 27, 1998), the Circuit Court Judge held that the income interest of a surviving spouse in the QTIP trust is charged against the elective share as

though it were a life estate valued under Va. Code §55-269.1.<sup>4</sup>

e. In *In re: Estate of Robert DeShazo*, the Commissioner of Accounts determined that some percentage of the QTIP is chargeable against the elective share for the ability of the surviving spouse to receive discretionary principal distributions. The Commissioner took evidence related to the language in the trust regarding the trustees' discretion, the surviving spouse's financial needs (health and otherwise), the surviving spouse's other resources and the presumed level of income distributions from the QTIP trust. The Circuit Court confirmed the Commissioner of Accounts holding that ten percent (10%) of the value of the QTIP trust should be charged to the spouse against her elective share for the potential principal distributions that could be made.

f. Courts in other states have struggled with the issue of how to value partial interests in trusts, including whether to allow for blockage discounts or to apply similar federal valuation concepts. See generally Volkmer, Ronald R., "The Complicated World of the Electing Spouse: In Re Estate of Myers and Recent Statutory Developments," 33 Creighton L. Rev. 121, 126 & 164-66 (December, 1999) (discussing generally the approaches of different states in addressing the valuation of QTIP trusts and specifically discussing a case decided by the Nebraska Supreme Court where the Court upheld the lower court in charging the income interest of a trust created by the decedent for the benefit of the surviving spouse to the surviving spouse and calculating the value of such trust by using the federal regulations applicable for valuing a present interest in a life estate).

g. In the 1990 and 1993 versions of UPC, there are no provisions articulating a valuation standard for partial interests other than a reference to "commuted" value but how that commuted value is to be computed is left open. According to the chief architects of the 1990 redesigned elective share provisions of the UPC, the failure to reference tax tables used by the federal government for valuation of partial interests was purposeful. *In Re Estate of Meyers and Recent Statutory Developments*, 33 Creighton L. Rev. at 142. The thought was that the failure to specifically address valuation issues would allow the parties more flexibility in resolving the issue through negotiation and agreement rather than litigation.

## 12. Marital Deduction for Elective Share Claim.

a. In *Estate of Agnello v. Commissioner*, 103 T.C. 605, 609 (1994) a settlement agreement was entered into among the estate, children from a prior marriage and the surviving spouse where the spouse agreed to receive a total of \$629,107 in assets from the decedent's estate in response to her elective share claim in exchange for an agreement from the surviving spouse that the settlement "was inclusive of any and all rights of the surviving spouse's to share in any post-death appreciation of assets included as part of the augmented estate." The executor could not document computations of any amounts used or asserted in the negotiation of the settlement agreement stating that the estate was anxious that the litigation be

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<sup>4</sup> The information on this case was taken from an outline by Stuart C. White, "Some Augmented Estate Issues and Planning and Administration Considerations" which was presented to Wills, Estates & Trusts Section, Fairfax Bar Association on April 29, 1998.

concluded because of mounting legal costs and the negotiations became an attempt to find an agreeable dollar amount, rather than to expose the estate to the hazards and expense of litigation. The IRS calculated what the elective share would have been under New Jersey law had the parties followed the statute and determined it was \$156,546 less than what the case settled for. The parties stipulated to this fact. The Tax Court held that only the date of death value of the elective share claim of the surviving spouse could qualify for a marital deduction (i.e. \$156,546 less than what was claimed by the estate) because §20.2056(b)-4(a) of the Treasury Regulations requires that the value, for the purpose of the marital deduction of any deductible interest (an interest passing from the decedent to his or her surviving spouse), be determined as of the date of decedent's death. The Court held that the Commissioner properly disallowed the portion of the marital deduction claimed on the estate tax return that was attributable to post-death increases in the value of the estate assets (that is the difference between the amount claimed on the estate tax return and the surviving spouse's one-third elective share of the augmented estate as determined under New Jersey law using date of death values for the estate assets). The Court noted that the record was devoid of any facts tending to establish that the deduction disallowed included anything other than post-death enhancement of the decedent's property passing to his widow and that there must be an assumption unless proven otherwise, that the base upon which the arm's length negotiations were conducted included post-death accretions to the estate.

b. The IRS concern is that the elective share amount as finally paid may depend upon post-mortem events such as appreciation on the assets (as was contemplated in the settlement agreement in *Estate of Agnello*). Under the IRC, the availability of the marital deduction depends on assets "passing from" the deceased spouse to the surviving spouse with such amount being fixed and determinable within six months.

c. The Court in *Estate of Agnello* in disallowing a marital deduction for post-death appreciation of assets focused on the requirement in the Code that the assets passing to the spouse must be included in the gross estate and that the value of the gross estate must be determined as of the date of death (or alternate valuation date). Post-death appreciation would not be included in the gross estate because it is not the date of death value. The question is how would Virginia's six percent (6%) statutory interest payable on the elective share amount until the date of satisfaction be classified given that the amount of interest is not tied to actual post-death appreciation.

d. If the 6% interest earned under Virginia law on the elective share until the date of satisfaction does not qualify for the marital deduction, can the interest payable on the elective share claim be deducted as an estate administration expense? Normally, interest on bequests is not deductible because it is not an expense that is "necessary" to estate administration but is instead an offset to the benefit received by the estate for the delay in distributions. The same argument could be made that interest on elective share is to offset benefits to the estate and/or distributees for delay in determining and satisfying the elective share.

13. Life Insurance and POD Accounts Owned by Decedent Alone at Death But Payable to Someone Other Than the Surviving Spouse: Included in Augmented Estate? Does it Matter Whether the Beneficiary is Designated Before or During Marriage?

a. Examine each inclusion paragraph of Va. Code §64.1-16.1 to see if it fits into a particular category.

b. Va. Code §64.1-16.1(A) is the first paragraph. This paragraph includes in the augmented estate those assets passing “by testate or intestate succession” after certain deductions. It would appear, therefore, that this provision would not include assets passing under a beneficiary designation such as a life insurance policy or a payable on death account because unless the beneficiary designation on the life insurance policy or payable on death account refers to the estate, the proceeds would not pass by testate or intestate succession but rather to the designated beneficiary.

c. Va. Code §64.1-16.1(A)(1) and (2) would not cause inclusion of the decedent’s life insurance policies or payable on death accounts payable to persons other than the surviving spouse because those provisions only relate to what the surviving spouse derived from the decedent.

d. Va. Code §64.1-16.1(A)(3) causes inclusion of only those assets transferred by the decedent “during the marriage” to someone other than a bona fide purchaser or for full and adequate consideration if the decedent retained certain rights. If a life insurance policy or the payable on death account is owned by the decedent at the time of his death and at the moment of death the marriage ends and at the same time the proceeds (or account) becomes payable to the named beneficiary, arguably there has been no “transfer” of the policy or account by the decedent “during the marriage” unless it could be argued that a “transfer” occurred before the marriage ended at death.

e. In *Felix-Aranibar v. Felix*, 59 Va. Cir. 357 (2002), the Arlington County Circuit Court held that a group life insurance policy owned by decedent at the time of death that designated a son from prior marriage as a beneficiary of the life insurance was fully includible in augmented estate because the term “estate” and “the value of property” which is found throughout each subsection of the augmented estate statute is later defined under subsection D of Va. Code §64.1-16.1 as including insurance policies. The Circuit Court did not specify which subsection captures the group life insurance policy.

f. One commentator disagrees with the notion that the “transfer” of a life insurance policy occurs at death. Professor Rodney Johnson disagrees with the idea that the rights of a beneficiary in a life insurance policy are created at death. Instead, the moment of death is the *consummation* of the prior transfer by beneficiary designation. He would conclude, therefore, that no “transfer” occurs at death but that the transfer occurs when the decedent owner of the life insurance policy *designates* a beneficiary because that beneficiary acquires some rights at that point. Under this view, it is the timing of the beneficiary designation that is important, whether done before or during the marriage. There is arguably support for Professor Johnson’s position in the very cases cited by the *Felix-Aranibar* Court discussed earlier and below. See *Smith v. Coleman*, 184 Va. 259, 35 S.E. 2d 107 (1945) *citing* the proposition in *Walker v. Penick’s, Ex’r*, 122 Va. 664, 95 S.E. 428 (1917) that the decedent’s designation of his daughter as a beneficiary of a life insurance policy on his life was a gift from him and the gift becomes effectual upon the death of the donor (with the daughter’s rights to recover on the

policy being accrued at the death of the decedent); *Bickers v. Shenandoah Valley Nat'l Bank*, 197 Va. 145, 88 S.E. 2d 889 (Va. 1955).

g. Contrast the position taken by Professor Johnson with the position taken by the Circuit Court of the County of Arlington in *Felix-Aranibar v. Felix*, (holding that a transfer of a life insurance policy does not occur simply by naming a beneficiary of the proceeds of the policy upon death because the beneficiary has no vested interest in the policy but just a mere expectancy similar to that of a legatee during the life of the testator and the right of the decedent as the insured to the contract of insurance is absolute). The decedent insured could have still defeated the expectancy of the beneficiary in many ways by exercising the power of appointment and naming another beneficiary. In *Felix-Aranibar*, the Court focused on whether the decedent, in naming his child from a prior marriage as the beneficiary of his group life insurance policy before marriage, actually divested himself of an interest in the subject matter or only made an illusory transfer during his lifetime and concluded that a transfer of the life insurance policy did not occur before marriage by simply naming the son as a beneficiary since title to the life insurance policy had not divested from the decedent.

h. Va. Code §64.1-16.1 (C)(2) defines “the value of an insurance policy that is irrevocably transferred during the lifetime of a decedent is the cost of a comparable policy on the date of transfer, or if such a policy is not readily available, the policy’s interpolated terminal reserve.” Further, “the value of any premiums paid on an insurance policy owned by another person is the amount of the premiums only and not the insurance purchased or maintained with such premiums.” This section sets out a valuation rule for life insurance policies, not an inclusion provision. Is this section sufficient to make an argument to support the conclusion reached by the *Felix-Aranibar* Court that life insurance policy proceeds are includible if owned by the decedent at the time of his death? Could an argument be made that the negative implication of the requirement that only the premiums paid during the marriage are included if the policy is owned by a third party mean that if the policy is not owned by a third person (i.e. it is owned by the decedent), then the entire asset is included?

i. Professor Johnson has suggested the following three different potential arguments for inclusion or exclusion of the proceeds of life insurance policies owned by the decedent at the time of his death based on the implications that can be drawn from the valuation rule in Va. Code §64.1-16.1 (C)(2): (1) none of the policy proceeds are included because the policies was not transferred during the marriage; (2) all of the proceeds to the extent that premiums were paid during the marriage because the premiums paid during marriage kept the whole policies in force; and (3) inclusion of some of the proceeds based on the contribution during the marriage of a portion of the premiums necessary to keep the policies intact (i.e. if 50% of the premiums paid during the marriage, then 50% of the insurance proceeds should be included).

j. Consider whether simply including the value of the premiums paid during marriage would be more appropriate and only to the extent the payment would fit into one of the inclusion rules.

k. The conclusion that life insurance policies owned by the decedent at death and payable to a third party are *not* included in the augmented estate would be consistent with the UPC. The UPC specifically excluded life insurance proceeds from the augmented estate on the grounds that life insurance was not generally used as a means to defeat a surviving spouse's interest in the decedent's estate and that life insurance was purchased for other purposes. The Virginia statute, however, unlike the UPC does not contain the same explicit statement that nothing should be construed to include life insurance policies in the augmented estate.

l. Later revisions to the UPC under the RUPC to include POD accounts may suggest that POD accounts were not previously included in the augmented estate under the UPC. The UPC statute, like Virginia, was silent as to whether to include or exclude POD accounts.

m. Under RUPC §2-505, a new category was added to capture in the augmented estate those assets that the decedent either owned or owned in substance immediately before death but passed outside probate in order to capture life insurance policies, payable on death accounts and revocable trusts. *See* Article II, Part 2, RUPC Comment, p. 108.

14. Is Real Property Located in a State Other than Virginia and Titled in Virginia Decedent's Sole Name Includable in the Augmented Estate Under Virginia Law?

a. Va. Code §64.1-13 makes it clear that the rights of a surviving spouse in real property located in Virginia that was owned by a decedent who dies domiciled outside of Virginia are not governed by Virginia law. Instead, contrary to the general rule that the law of the situs of the real property controls, the Virginia statute directs that the law of the decedent's domicile controls the surviving spouse's interest in any real property located in Virginia.

b. The UPC contains the same provision. *See* §2-201(b). In the General Comments for Article II, Part 2 of the UPC, the Commissioners note that uniformity of law for the elective share of a surviving spouse is especially important so that states limit the applicability of rules protecting spouses to only estates of domiciliary decedents, presumably to avoid the situation where the surviving spouses of decedents domiciled in Virginia end up not having the same rights in their respective decedent spouses' estates because one Virginia decedent had property in another state controlled by that state law (giving greater or lesser rights to the surviving spouse).

c. If in fact all states had adopted the UPC or at a minimum §2-201(b) of the UPC, it would be clear that a surviving spouse's rights in real property of a Virginia decedent that is located outside the state of Virginia would be governed by the Virginia augmented estate statutes. Because not all states have adopted the UPC or may have adopted a modified (or revised) version of the UPC, the law of the state in which the real property is located will need to be examined first to determine whether the rights of the surviving spouse of a Virginia decedent is controlled by that state law or Virginia law.

## VII. THE REVISED UNIFORM CODE AND POSSIBLE SOLUTIONS

### 1. Section 2-202. Elective Share.

(a) **Elective-Share Amount.** The surviving spouse of a decedent who dies domiciled in this state has a right of election, under the limitations and conditions stated in this Part, to take an elective-share amount equal to the value of the elective-share percentage of the augmented estate, determined by the length of time the spouse and the decedent were married to each other, in accordance with the following schedule:

| If the decedent and the spouse<br>were married to<br>each other: | The elective-share<br>percentage is: |
|--|--------------------------------------|
| Less than 1 year .....   | Supplemental Amount Only.            |
| 1 year but less than 2 years .....                               | 3% of the augmented estate.          |
| 2 years but less than 3 years.....                               | 6% of the augmented estate.          |
| 3 years but less than 4 years.....                               | 9% of the augmented estate.          |
| 4 years but less than 5 years.....                               | 12% of the augmented estate.         |
| 5 years but less than 6 years.....                               | 15% of the augmented estate.         |
| 6 years but less than 7 years.....                               | 18% of the augmented estate.         |
| 7 years but less than 8 years.....                               | 21% of the augmented estate.         |
| 8 years but less than 9 years.....                               | 24% of the augmented estate.         |
| 9 years but less than 10 years.....                              | 27% of the augmented estate.         |
| 10 years but less than 11 years.....                             | 30% of the augmented estate.         |
| 11 years but less than 12 years.....                             | 34% of the augmented estate.         |
| 12 years but less than 13 years.....                             | 38% of the augmented estate.         |
| 13 years but less than 14 years.....                             | 42% of the augmented estate.         |
| 14 years but less than 15 years.....                             | 46% of the augmented estate.         |
| 15 years or more.....  | 50% of the augmented estate.         |

(b) **Supplemental Elective-Share Amount.** If the sum of the amounts described in Sections 2-207, 2-209(a)(1), and that part of the elective-share amount payable from the decedent's probate estate and nonprobate transfers to others under Section 2-209(b) and (c) is less than [\$50,000], the surviving spouse is entitled to a supplemental elective-share amount equal to [\$50,000], minus the sum of the amounts described in those sections. The supplemental elective-share amount is payable from the decedent's probate estate and from recipients of the decedent's nonprobate transfers to others in the order of priority set forth in Section 2-209(b) and (c).

(c) **Effect of Election on Statutory Benefits.** If the right of election is exercised by or on behalf of the surviving spouse, the surviving spouse's homestead allowance, exempt property, and family allowance, if any, are not charged against but are in addition to the elective-share and supplemental elective-share amounts.

(d) **Non-Domiciliary.** The right, if any, of the surviving spouse of a decedent who dies domiciled outside this State to take an elective share in property in this State is governed by the law of the decedent's domicile at death.

(e) Adoption of the provisions of §2-202(a) would move Virginia closer to economic partnership theory regarding marital property and further from the support theory

(f) The length of marriage is an imperfect measure of the contributions made by each party, but easier to accept that an automatic vesting of 1/3 (or 1/2) immediately upon marriage.

(g) The supplemental elective share amount in §2-202(b), in conjunction with Va. Code §64.1-151.1 would give the surviving spouse a small amount necessary for support. In effect, this provision creates a “minimum” amount to which a survivor is entitled simply by reason of marriage.

## 2. **Section 2-203. Composition of the Augmented Estate.**

(a) Subject to Section 2-208, the value of the augmented estate, to the extent provided in Sections 2-204, 2-205, 2-206, and 2-207, consists of the sum of the values of all property, whether real or personal; movable or immovable, tangible or intangible, wherever situated, that constitute the decedent's net probate estate, the decedent's nonprobate transfers to others, the decedent's nonprobate transfers to the surviving spouse, and the surviving spouse's property and nonprobate transfers to others.

(b) The inclusion of the surviving spouse's property and nonprobate transfers conform to the partnership theory of marital assets and prevents titling issues and order of death from unjustly benefiting the family of one spouse over the other.

## 3. **Section 2-204. Decedent's Net Probate Estate.**

(a) The value of the augmented estate includes the value of the decedent's probate estate, reduced by funeral and administration expenses, homestead allowance, family allowances, exempt property, and enforceable claims.

(b) Note that “federal or state transfer taxes” are not excluded specifically under §2-204, but could be under the term “enforceable claims”. The comment to this Section refers back to the definition of “claims” in RUPC §1-201 to exclude:

1. estate or inheritance taxes; or
2. demands or disputes regarding title of a decedent or protected person to specific assets alleged to be included in the estate.

**4. Section 2-205. Decedent's Nonprobate Transfers to Others.**

The value of the augmented estate includes the value of the decedent's nonprobate transfers to others, not included under Section 2-204, of any of the following types, in the amount provided respectively for each type of transfer:

(1) Property owned or owned in substance by the decedent immediately before death that passed outside probate at the decedent's death. Property included under this category consists of:

(i) Property over which the decedent alone, immediately before death, held a presently exercisable general power of appointment. The amount included is the value of the property subject to the power, to the extent the property passed at the decedent's death, by exercise, release, lapse, in default, or otherwise, to or for the benefit of any person other than the decedent's estate or surviving spouse.

(ii) The decedent's fractional interest in property held by the decedent in joint tenancy with the right of survivorship. The amount included is the value of the decedent's fractional interest, to the extent the fractional interest passed by right of survivorship at the decedent's death to a surviving joint tenant other than the decedent's surviving spouse.

(iii) The decedent's ownership interest in property or accounts held in POD, TOD, or co-ownership registration with the right of survivorship. The amount included is the value of the decedent's ownership interest, to the extent the decedent's ownership interest passed at the decedent's death to or for the benefit of any person other than the decedent's estate or surviving spouse.

(iv) Proceeds of insurance, including accidental death benefits, on the life of the decedent, if the decedent owned the insurance policy immediately before death or if and to the extent the decedent alone and immediately before death held a presently exercisable general power of appointment over the policy or its proceeds. The amount included is the value of the proceeds, to the extent they were payable at the decedent's death to or for the benefit of any person other than the decedent's estate or surviving spouse.

(2) Property transferred in any of the following forms by the decedent during marriage:

(i) Any irrevocable transfer in which the decedent retained the right to the possession or enjoyment of, or to the income from, the property if and to the extent the decedent's right terminated at or continued beyond the decedent's death. The amount included is the value

of the fraction of the property to which the decedent's right related, to the extent the fraction of the property passed outside probate to or for the benefit of any person other than the decedent's estate or surviving spouse.

(ii) Any transfer in which the decedent created a power over income or property, exercisable by the decedent alone or in conjunction with any other person, or exercisable by a nonadverse party, to or for the benefit of the decedent, creditors of the decedent, the decedent's estate, or creditors of the decedent's estate. The amount included with respect to a power over property is the value of the property subject to the power, and the amount included with respect to a power over income is the value of the property that produces or produced the income, to the extent the power in either case was exercisable at the decedent's death to or for the benefit of any person other than the decedent's surviving spouse or to the extent the property passed at the decedent's death, by exercise, release, lapse, in default, or otherwise, to or for the benefit of any person other than the decedent's estate or surviving spouse. If the power is a power over both income and property and the preceding sentence produces different amounts, the amount included is the greater amount.

(3) Property that passed during marriage and during the two-year period next preceding the decedent's death as a result of a transfer by the decedent if the transfer was of any of the following types:

(i) Any property that passed as a result of the termination of a right or interest in, or power over, property that would have been included in the augmented estate under paragraph (1)(i), (ii), or (iii), or under paragraph (2), if the right, interest, or power had not terminated until the decedent's death. The amount included is the value of the property that would have been included under those paragraphs if the property were valued at the time the right, interest, or power terminated, and is included only to the extent the property passed upon termination to or for the benefit of any person other than the decedent or the decedent's estate, spouse, or surviving spouse. As used in this subparagraph, "termination," with respect to a right or interest in property, occurs when the right or interest terminated by the terms of the governing instrument or the decedent transferred or relinquished the right or interest, and, with respect to a power over property, occurs when the power terminated by exercise, release, lapse, default, or otherwise, but, with respect to a power described in paragraph (1)(i), "termination" occurs when the power terminated by exercise or release, but not otherwise.

(ii) Any transfer of or relating to an insurance policy on the life of the decedent if the proceeds would have been included in the augmented estate under paragraph (1)(iv) had the transfer not occurred.

The amount included is the value of the insurance proceeds to the extent the proceeds were payable at the decedent's death to or for the benefit of any person other than the decedent's estate or surviving spouse.

(iii) Any transfer of property, to the extent not otherwise included in the augmented estate, made to or for the benefit of a person other than the decedent's surviving spouse. The amount included is the value of the transferred property to the extent the aggregate transfers to any one donee in either of the two years exceeded \$10,000.

(b) Note that the provisions of §2-205 are more explicit than current Va. Code §64.1-16.1.

(c) The “look back” provision is limited to two (2) years and for gifts exceeding Ten Thousand Dollars (\$10,000.00) per year.

1. Va. Code §64.1-16.1 uses a six (6) year “look back” provision. Considering there is little recourse a spouse may have to prevent lifetime gifting to reduce the augmented estate, the extended Virginia look back offers a greater cure in the event of a systematic depletion of the estate.

2. The statute continues to refer to the Ten Thousand Dollars (\$10,000.00) gift level, making nontaxable gifts under IRC §2503 partially excluded for augmented estate purposes.

3. Consideration should be made to link this statute with the federal gift tax annual exclusion amount under IRC §2503, for the year in which such gratuitous transfers are made.

**5. Section 2-206. Decedent's Nonprobate Transfers to the Surviving Spouse.**

(a) Excluding property passing to the surviving spouse under the federal Social Security system, the value of the augmented estate includes the value of the decedent's nonprobate transfers to the decedent's surviving spouse, which consist of all property that passed outside probate at the decedent's death from the decedent to the surviving spouse by reason of the decedent's death, including:

(1) the decedent's fractional interest in property held as a joint tenant with the right of survivorship, to the extent that the decedent's fractional interest passed to the surviving spouse as surviving joint tenant,

(2) the decedent's ownership interest in property or accounts held in co-ownership registration with the right of survivorship, to the extent the decedent's ownership interest passed to the surviving spouse as surviving co-owner, and

(3) all other property that would have been included in the augmented estate under Section 2-205(1) or (2) had it passed to or for the benefit of a

person other than the decedent's spouse, surviving spouse, the decedent, or the decedent's creditors, estate, or estate creditors.

(b) §2-206 clarifies that jointly held property, right of survivorship property and POD and TOD property are to be considered in valuing the spouse's augmented estate rights.

**6. Section 2-207. Surviving Spouse's Property and Nonprobate Transfers to Others.**

(a) **Included Property.** Except to the extent included in the augmented estate under Section 2-204 or 2-206, the value of the augmented estate includes the value of:

(1) property that was owned by the decedent's surviving spouse at the decedent's death, including:

(i) the surviving spouse's fractional interest in property held in joint tenancy with the right of survivorship,

(ii) the surviving spouse's ownership interest in property or accounts held in co-ownership registration with the right of survivorship, and

(iii) property that passed to the surviving spouse by reason of the decedent's death, but not including the spouse's right to homestead allowance, family allowance, exempt property, or payments under the federal Social Security system; and

(2) property that would have been included in the surviving spouse's nonprobate transfers to others, other than the spouse's fractional and ownership interests included under subsection (a)(1)(i) or (ii), had the spouse been the decedent.

(b) **Time of Valuation.** Property included under this section is valued at the decedent's death, taking the fact that the decedent predeceased the spouse into account, but, for purposes of subsection (a)(1)(i) and (ii), the values of the spouse's fractional and ownership interests are determined immediately before the decedent's death if the decedent was then a joint tenant or a co-owner of the property or accounts. For purposes of subsection (a)(2), proceeds of insurance that would have been included in the spouse's nonprobate transfers to others under Section 2-205(1)(iv) are not valued as if he [or she] were deceased.

(c) **Reduction for Enforceable Claims.** The value of property included under this section is reduced by enforceable claims against the surviving spouse.

(d) This section establishes a component presently unaccounted for in Virginia and is designed to approximate the "economic partnership" theory by using these

amounts first to “equalize” the estates.

7. **Section 2-208. Exclusions, Valuation, and Overlapping Application.**

(a) **Exclusions.** The value of any property is excluded from the decedent's nonprobate transfers to others (i) to the extent the decedent received adequate and full consideration in money or money's worth for a transfer of the property or (ii) if the property was transferred with the written joinder of, or if the transfer was consented to in writing by, the surviving spouse.

(b) **Valuation.** The value of property:

(1) included in the augmented estate under Section 2-205, 2-206, or 2-207 is reduced in each category by enforceable claims against the included property; and

(2) includes the commuted value of any present or future interest and the commuted value of amounts payable under any trust, life insurance settlement option, annuity contract, public or private pension, disability compensation, death benefit or retirement plan, or any similar arrangement, exclusive of the federal Social Security system.

(c) **Overlapping Application; No Double Inclusion.** In case of overlapping application to the same property of the paragraphs or subparagraphs of Section 2-205, 2-206, or 2-207, the property is included in the augmented estate under the provision yielding the greatest value, and under only one overlapping provision if they all yield the same value.

(d) Note that the transfer of property by gift requires the joinder or consent of the surviving spouse, in writing, to the transfer. The comments clarify that consent to gift-splitting treatment under IRC §2513 is *not* intended to cover such an exclusion. The statute should be more explicit so that reliance on the comments for authority would not be required.

2. CRATs and CRUTs would be included under the RUPC unless spousal consent to the transfer was obtained.

8. **Section 2-209. Sources from Which Elective Share Payable.**

(a) **Elective-Share Amount Only.** In a proceeding for an elective share, the following are applied first to satisfy the elective-share amount and to reduce or eliminate any contributions due from the decedent's probate estate and recipients of the decedent's nonprobate transfers to others:

(1) amounts included in the augmented estate under Section 2-204 which pass or have passed to the surviving spouse by testate or intestate succession and amounts included in the augmented estate under Section 2-206; and

(2) amounts included in the augmented estate under Section 2-207 up to the applicable percentage thereof. For the purposes of this subsection, the "applicable percentage" is twice the elective-share percentage set forth in the schedule in Section 2-202(a) appropriate to the length of time the spouse and the decedent were married to each other.

**(b) Unsatisfied Balance of Elective-Share Amount; Supplemental Elective-Share Amount.** If, after the application of subsection (a), the elective-share amount is not fully satisfied or the surviving spouse is entitled to a supplemental elective-share amount, amounts included in the decedent's probate estate and in the decedent's nonprobate transfers to others, other than amounts included under Section 2-205(3)(i) or (iii), are applied first to satisfy the unsatisfied balance of the elective-share amount or the supplemental elective-share amount. The decedent's probate estate and that portion of the decedent's nonprobate transfers to others are so applied that liability for the unsatisfied balance of the elective-share amount or for the supplemental elective-share amount is equitably apportioned among the recipients of the decedent's probate estate and of that portion of the decedent's nonprobate transfers to others in proportion to the value of their interests therein.

**(c) Unsatisfied Balance of Elective-Share and Supplemental Elective-Share Amounts.** If, after the application of subsections (a) and (b), the elective-share or supplemental elective-share amount is not fully satisfied, the remaining portion of the decedent's nonprobate transfers to others is so applied that liability for the unsatisfied balance of the elective-share or supplemental elective-share amount is equitably apportioned among the recipients of the remaining portion of the decedent's nonprobate transfers to others in proportion to the value of their interests therein.

#### **9. Section 2-210. Personal Liability of Recipients.**

(a) Only original recipients of the decedent's nonprobate transfers to others, and the donees of the recipients of the decedent's nonprobate transfers to others, to the extent the donees have the property or its proceeds, are liable to make a proportional contribution toward satisfaction of the surviving spouse's elective-share or supplemental elective-share amount. A person liable to make contribution may choose to give up the proportional part of the decedent's nonprobate transfers to him [or her] or to pay the value of the amount for which he [or she] is liable.

(b) If any section or part of any section of this Part is preempted by federal law with respect to a payment, an item of property, or any other benefit included in the decedent's nonprobate transfers to others, a person who, not for value, receives the payment, item of property, or any other benefit is obligated to return the payment, item of property, or benefit, or is personally liable for the amount of the payment or the value of that item of property or benefit, as provided in Section 2-209, to the person who would have been entitled to it were that section or part of that section not preempted.

#### **10. Section 2-211. Proceeding for Elective Share; Time Limit.**

(a) Except as provided in subsection (b), the election must be made by filing

in the Court and mailing or delivering to the personal representative, if any, a petition for the elective share within nine months after the date of the decedent's death, or within six months after the probate of the decedent's will, whichever limitation later expires. The surviving spouse must give notice of the time and place set for hearing to persons interested in the estate and to the distributees and recipients of portions of the augmented estate whose interests will be adversely affected by the taking of the elective share. Except as provided in subsection (b), the decedent's nonprobate transfers to others are not included within the augmented estate for the purpose of computing the elective-share, if the petition is filed more than nine months after the decedent's death.

(b) Within nine months after the decedent's death, the surviving spouse may petition the court for an extension of time for making an election. If, within nine months after the decedent's death, the spouse gives notice of the petition to all persons interested in the decedent's nonprobate transfers to others, the court for cause shown by the surviving spouse may extend the time for election. If the court grants the spouse's petition for an extension, the decedent's nonprobate transfers to others are not excluded from the augmented estate for the purpose of computing the elective-share and supplemental elective-share amounts, if the spouse makes an election by filing in the court and mailing or delivering to the personal representative, if any, a petition for the elective share within the time allowed by the extension.

(c) The surviving spouse may withdraw his [or her] demand for an elective share at any time before entry of a final determination by the court.

(d) After notice and hearing, the court shall determine the elective-share and supplemental elective-share amounts, and shall order its payment from the assets of the augmented estate or by contribution as appears appropriate under Sections 2-209 and 2-210. If it appears that a fund or property included in the augmented estate has not come into the possession of the personal representative, or has been distributed by the personal representative, the court nevertheless shall fix the liability of any person who has any interest in the fund or property or who has possession thereof, whether as trustee or otherwise. The proceeding may be maintained against fewer than all persons against whom relief could be sought, but no person is subject to contribution in any greater amount than he [or she] would have been under Sections 2-209 and 2-210 had relief been secured against all persons subject to contribution.

(e) An order or judgment of the court may be enforced as necessary in suit for contribution or payment in other courts of this State or other jurisdictions.

(f) The addition of a limitations period of "nine months from date of death" puts a terminus on any claim.

11. **Section 2-212. Right of Election Personal to Surviving Spouse; Incapacitated Surviving Spouse.**

(a) **Surviving Spouse Must Be Living at Time of Election.** The right of election may be exercised only by a surviving spouse who is living when the petition for the elective share is filed in the court under Section 2-211(a). If the election is not exercised by the

surviving spouse personally, it may be exercised on the surviving spouse's behalf by his [or her] conservator, guardian, or agent under the authority of a power of attorney.

(b) **Incapacitated Surviving Spouse.** If the election is exercised on behalf of a surviving spouse who is an incapacitated person, that portion of the elective-share and supplemental elective-share amounts due from the decedent's probate estate and recipients of the decedent's nonprobate transfers to others under Section 2-209(b) and (c) must be placed in a custodial trust for the benefit of the surviving spouse under the provisions of the [Enacting state] Uniform Custodial Trust Act, except as modified below. For the purposes of this subsection, an election on behalf of a surviving spouse by an agent under a durable power of attorney is presumed to be on behalf of a surviving spouse who is an incapacitated person. For purposes of the custodial trust established by this subsection, (i) the electing guardian, conservator, or agent is the custodial trustee, (ii) the surviving spouse is the beneficiary, and (iii) the custodial trust is deemed to have been created by the decedent spouse by written transfer that takes effect at the decedent spouse's death and that directs the custodial trustee to administer the custodial trust as for an incapacitated beneficiary.

(c) **Custodial Trust.** For the purposes of subsection (b), the [Enacting state] Uniform Custodial Trust Act must be applied as if Section 6(b) thereof were repealed and Sections 2(e), 9(b), and 17(a) were amended to read as follows:

(1) Neither an incapacitated beneficiary nor anyone acting on behalf of an incapacitated beneficiary has a power to terminate the custodial trust; but if the beneficiary regains capacity, the beneficiary then acquires the power to terminate the custodial trust by delivering to the custodial trustee a writing signed by the beneficiary declaring the termination. If not previously terminated, the custodial trust terminates on the death of the beneficiary.

(2) If the beneficiary is incapacitated, the custodial trustee shall expend so much or all of the custodial trust property as the custodial trustee considers advisable for the use and benefit of the beneficiary and individuals who were supported by the beneficiary when the beneficiary became incapacitated, or who are legally entitled to support by the beneficiary. Expenditures may be made in the manner, when, and to the extent that the custodial trustee determines suitable and proper, without court order but with regard to other support, income, and property of the beneficiary [exclusive of] [and] benefits of medical or other forms of assistance from any state or federal government or governmental agency for which the beneficiary must qualify on the basis of need.

Upon the beneficiary's death, the custodial trustee shall transfer the unexpended custodial trust property in the following order: (i) under the residuary clause, if any, of the will of the beneficiary's predeceased spouse against whom the elective share was taken, as if that predeceased spouse died immediately after the beneficiary; or (ii) to that predeceased spouse's heirs under Section 2-711 of [this State's] Uniform Probate Code.

(d) Creation of a custodial trust prevents shifting of benefits away from the family of first spouse to die – especially when the surviving spouse does not outlive the first spouse by a significant period.

(e) This section also avoids the issue of making the election by an incapacitated spouse and designates that a conservator, guardian or agent under a durable power of attorney may make the election. Virginia does not currently authorize or restrict elections on behalf of an incapacitated spouse (*See* page 4 of this outline).

**12. Section 2-213. Waiver of Right to Elect and of Other Rights.**

(a) The right of election of a surviving spouse and the rights of the surviving spouse to homestead allowance, exempt property, and family allowance, or any of them, may be waived, wholly or partially, before or after marriage, by a written contract, agreement, or waiver signed by the surviving spouse.

(b) A surviving spouse's waiver is not enforceable if the surviving spouse proves that:

(1) he [or she] did not execute the waiver voluntarily; or

(2) the waiver was unconscionable when it was executed and, before execution of the waiver, he [or she]:

(i) was not provided a fair and reasonable disclosure of the property or financial obligations of the decedent;

(ii) did not voluntarily and expressly waive, in writing, any right to disclosure of the property or financial obligations of the decedent beyond the disclosure provided; and

(iii) did not have, or reasonably could not have had, an adequate knowledge of the property or financial obligations of the decedent.

(c) An issue of unconscionability of a waiver is for decision by the court as a matter of law.

(d) Unless it provides to the contrary, a waiver of "all rights," or equivalent language, in the property or estate of a present or prospective spouse or a complete property settlement entered into after or in anticipation of separation or divorce is a waiver of all rights of elective share, homestead allowance, exempt property, and family allowance by each spouse in the property of the other and a renunciation by each of all benefits that would otherwise pass to him [or her] from the other by intestate succession or by virtue of any will executed before the waiver or property settlement.

**13. Section 2-214. Protection of Payors and Other Third Parties.**

(a) Although under Section 2-205 a payment, item of property, or other

benefit is included in the decedent's nonprobate transfers to others, a payor or other third party is not liable for having made a payment or transferred an item of property or other benefit to a beneficiary designated in a governing instrument, or for having taken any other action in good faith reliance on the validity of a governing instrument, upon request and satisfactory proof of the decedent's death, before the payor or other third party received written notice from the surviving spouse or spouse's representative of an intention to file a petition for the elective share or that a petition for the elective share has been filed. A payor or other third party is liable for payments made or other actions taken after the payor or other third party received written notice of an intention to file a petition for the elective share or that a petition for the elective share has been filed.

(b) A written notice of intention to file a petition for the elective share or that a petition for the elective share has been filed must be mailed to the payor's or other third party's main office or home by registered or certified mail, return receipt requested, or served upon the payor or other third party in the same manner as a summons in a civil action. Upon receipt of written notice of intention to file a petition for the elective share or that a petition for the elective share has been filed, a payor or other third party may pay any amount owed or transfer or deposit any item of property held by it to or with the court having jurisdiction of the probate proceedings relating to the decedent's estate, or if no proceedings have been commenced, to or with the court having jurisdiction of probate proceedings relating to decedents' estates located in the county of the decedent's residence. The court shall hold the funds or item of property, and, upon its determination under Section 2-211(d), shall order disbursement in accordance with the determination. If no petition is filed in the court within the specified time under Section 2-211(a) or, if filed, the demand for an elective share is withdrawn under Section 2-211(c), the court shall order disbursement to the designated beneficiary. Payments or transfers to the court or deposits made into court discharge the payor or other third party from all claims for amounts so paid or the value of property so transferred or deposited.

(c) Upon petition to the probate court by the beneficiary designated in a governing instrument, the court may order that all or part of the property be paid to the beneficiary in an amount and subject to conditions consistent with this Part.

## **IX. CONCLUSION**

1. Considering the initial version of the UPC dealing with the augmented estate, even its proponents have recognized its complexity and controversial nature.
2. Virginia's several modifications to the UPC approach leave Virginia courts without much help from other jurisdictions on important issues of construction and interpretation.
3. As noted above, the UPC has evolved into the RUPC. While the RUPC addresses many of the technical problems that arose under the UPC, it also provides a fundamental redefinition of the entire concept of the forced share. Virginia has not adopted this view, also leaving Virginia courts without help from other jurisdictions which have adopted the RUPC. Virginia should strongly consider adoption of most

of the modifications brought about by the RUPC as they appear to be more consistent with the partnership theory of asset division, a theory that is more in line with the equitable distribution laws in effect at divorce.

4. Even in its current form, the Virginia statute is more fair than its predecessor. One almost certain effect will be that it will force spouses to more often deal directly between themselves on issues of property, either by joinder or marital agreement.
5. As to the proposed amendments to the Virginia laws outlined in this article, the author is reminded of a quote by the late Robert F. Kennedy:

“Some men see things as they are, and say ‘why’; I dream things that never were and ask ‘why not’?”

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