Estate & Succession Planning Corner

By Louis S. Harrison[1]

Marriage Is Joint; Why Not Your Trusts? When to Use a Joint Trust As a Passthrough Entity in Separate Property Jurisdictions

The Importance of Joint Trusts

Joint trusts—*avant garde* and often confused with that horrible species of instruments known as a "Joint Will"—have been shunned as an estate planning vehicle by most practitioners in common law states, such as Illinois. They are used almost exclusively for estate planning for married couples in community property states, but that is because the community property laws lend themselves (and often demand) that a jointly owned trust be used to hold community assets.

In common law states, it generally has been agreed that the uncertainty of the gift tax consequences and the probability of adverse estate tax consequences militated against a joint trust in all but the most modest of estates. In recent years, though only in private rulings, the IRS has provided the roadmap for how a joint trust could work in taxable estates. And the joint trust could be the vehicle of choice for a select number of clients, noted below.

When to Use a Joint Trust in Separate Property Jurisdictions

A joint trust is a trust document created by a married couple where both spouses are the grantors of the trust. The document usually contains provisions for the benefit of both spouses while both spouses are living (their joint lives), for the surviving spouse after the first spouse dies and for the descendants or other beneficiaries who are to receive the trust assets after the death of the surviving spouse. This document is the primary estate planning document for the couple, and each of them has a pour-over will naming this joint trust as the beneficiary of his or her estate.

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Property in a joint trust is not kept separate, as would be the case with a community property joint trust (which details out each spouse's separate property and community property throughout the document and in the schedules attached).

The practitioner will want to consider the joint trust in a separate property jurisdiction primarily in the following circumstances:

- **A need to simplify the clients' understanding of their estates plan.** Two trusts, and the subtrusts created thereunder, are extremely difficult for laypeople to understand. A joint trust is more understandable: The clients do not have to conceptualize assets going into two different pots, with children's trusts being created from multiple different trust documents at the surviving spouse's passing.
- **All of the clients' ownership is and will remain "joint."** By transferring title of property to a joint trust, the clients get to see both of their names on the property and get to feel that nothing fundamental has changed. This is not the case when they are forced to split property between two separate trusts.
- **Difficulty of funding the credit shelter trust for the "nonpropertied" spouse.** Often, it is difficult to discuss and reallocate assets to make sure that each credit shelter trust is funded to the maximum extent possible, which will depend on which spouse predeceases the other and what assets that spouse owns. Assuming the letter rulings are correct in their advice, this problem can be avoided by having all assets transferred to the joint trust. But with the good comes the bad: eliminating the underfunded problem could create problems at divorce once these assets have been retitled.[2]
- **Full basis step up-in the hand of the survivor as to non-IRD assets.** There is still much uncertainty in this area; and the use of the joint trust to try to achieve a favorable basis step-up as to ALL of the property may not occur.

Careful with that Axe Eugene: When Not to Use a Joint Trust

Loss of Separate Identity of Property for Divorce and Other Purposes

If assets are transferred to a joint trust, the separate identity of the property could be lost for purposes of divorce. Practitioners, including divorce attorneys, may argue to the contrary, especially if there is bookkeeping of "his, hers and ours" maintained within the joint trust. But that seems like an accident waiting to happen. If the transmutation of separate property to marital property could be a problem, then the joint trust just should *not* be used. It is much simpler in that case, if the goal is to preserve the separate nature of property, to use separate trusts.[3]

Loss of Creditor Protection

All of the assets of both spouses may become subject to the claims of creditors of just one spouse. In addition, all of the assets of both spouses may become subject to the environmental liabilities of just one spouse's separate property. These results can usually be avoided if separate trusts are used.

Tax Risks: Not Unifying the Credit?

The issue involves what is becoming the most troublesome estate tax section, Code Sec. 2036. Code Sec. 2036 provides:

> GENERAL RULE.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has 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—
>
> i. The possession or enjoyment of, or the right to the income from, the property, or
> ii. The right, either alone in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

If, after the death of the first spouse, the surviving spouse (1) is the trustee of all of the assets of the joint trust *or* (2) receives the income from all of the assets of the joint trust, then all of the assets may be includible in the surviving spouse's estate by reasons of Code Sec. 2036 (in an improperly drafted joint trust). All of the unified credit of the first spouse to die is wasted, and unnecessary estate tax may be paid in the second estate.[4]

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Avoiding Taxable Gift on Funding and at the First Spouse's Death

Taxable gifts may be made by the spouses to each other when the trust is funded, and those gifts may not qualify for the marital deduction. If one transfers property to a trust beyond his or her unilateral control, then arguably there has been a divestment of the enjoyment of property and a gift for a gift tax purposes. Though the other spouse is a beneficiary, that gift may not qualify for the marital deduction.

The IRS to the Rescue[5]

Recent letter rulings now suggest that a joint trust will work even in a taxable estate, and that the credit shelter trust and taxable gift concerns noted above can be avoided. In planning for a potentially taxable situation (that is, where the clients' combined assets exceed one estate tax exemption—greater than $1.5 million in 2005, greater than $2 million in 2006 and so on), it is important to draft the joint trust to fall within the boundaries expressed in the recent LTRs, and specifically LTR 200101021,[6] discussed below.

> In recent years, though only in private rulings, the IRS has provided the roadmap for how a joint trust could work in taxable estates.

First, each spouse must have a *unilateral* right to terminate the trust. This will either (1) prevent a completed gift; or (2) if there is a completed gift, that gift will qualify for the marital deduction. For example, if on termination each spouse gets back what that spouse contributed, there is *no* completed gift.

If a spouse gets back less than what that spouse contributed, then there is a completed gift, but the gift qualifies for the marital deduction if the other spouse can terminate and get that property.

Example. Imagine one spouse contributing 90 percent of the property and the other 10 percent of the property to a joint trust. Each spouse has the unilateral right to terminate the trust, and on termination all property is distributed to the spouses as tenants-in-common. Because each spouse gets back 50 percent on a unilateral right to terminate, then one spouse has made a 40-percent gift to the other spouse. But this transfer is a completed gift because of the other spouse's unilateral right to obtain the excess. And further, the other spouse's unilateral right to obtain the excess qualifies the gift for the marital deduction.[7]

Drafting tip 1. To prevent completed gifts from occurring as to all the property contributed by one spouse to the other, or to make sure that if there is a completed gift it qualifies for the marital deduction, include two powers in the trust: (1) make sure that each spouse has the unilateral right to terminate the trust during their joint lifetimes, and (2) define what each spouse will get back on termination (though one LTR did not have this additional requirement and it did not raise a concern).

Second, in the ruling, the trust created a testamentary general power of appointment in the first spouse to pass away. As a result, the IRS ruled that the value of the entire joint trust would be includible in the estate of the first grantor to die.

Drafting tip 2. In order to avoid taxable gifts concerns by the second spouse at the passing of the first spouse, make sure the first spouse has a general power of appointment over all trust property at his or her passing. Further, because all property will be included in the first spouse's gross estate, this means that all property is available to fund the credit shelter trust. That is, property does not have to be allocated among spouses to allow for proper funding. Merely having the property in the joint trust is enough.

Third, because of the general power of appointment that the first spouse to die has over all the joint trust property, the IRS ruled that any property of the surviving grantor which passes to the Credit Shelter Trust will not be treated as a gift/transfer/assignment (or otherwise) by the surviving grantor. It will be treated instead as having been placed in the Credit Shelter Trust by the deceased grantor.

Drafting tip 3. In order to make sure the surviving spouse is not the "grantor," "transferor" or "creator" of any interest that the surviving spouse receives at the first spouse's passing under the joint trust, which is essential to preserve the credit shelter trust,[8] make sure the first spouse has a general power of appointment over all trust property at his or her passing.

What's All This About Powers of Appointment and Basis?

Code Sec. 1014(a) provides that the basis of property in the hands of a person acquiring the property from a decedent is the fair market value of the property at the date of the decedent's death (or alternate valuation date). Code Sec. 1014(e), however, provides an exception to the general rule of Code Sec. 1014(a). If appreciated property was acquired by the decedent by gift during the one-year period ending on the date of the decedent's death, and the property passes from the decedent to the donor of such property, the basis of such property in the hands of the donor is the adjusted basis of the property in the hands of the decedent immediately before the death of the decedent.

While practitioners believe (and older rulings indicate[9]) that if the property passed to a Family Trust, this meant it did not return "to" the donor, the IRS ruled otherwise. It ruled that Code Sec. 1014(e) will apply to any trust property includible in the deceased grantor's gross estate that is attributable to the surviving grantor's contribution to the trust and that is acquired by the surviving grantor, either directly or indirectly, pursuant to the deceased grantor's exercise or fail to exercise the general power of appointment.[10] The IRS may not be correct in its conclusion here. As John Martin points out in his article on joint trusts in REAL PROPERTY, PROBATE AND TRUST JOURNAL:

> The application of section 1014(e) to the Tax Plan Joint Trust may be challenged. It clearly rests on recognizing a gift from the surviving spouse to the first spouse to die at the instant of the first spouse's death. A gift that is triggered by the death of the donee possesses a certain mythical element. More critically, a relinquishment of dominion and control is difficult to see when the surviving spouse possessed control before the decedent's death."[11]

It remains to be seen whether the basis adjustment, to a full step up at the first spouse's passing, is sustainable.

The Pragmatics: To Be (a Joint Trust) or Not to Be (a Joint Trust)

Consider joint trusts in separate property jurisdictions for clients that will have trouble allocating assets between themselves to fund the credit shelter trust, being sure to include a general power of appointment exercisable by the first spouse to die in the trust agreement. Also consider a joint trust in a separate property jurisdiction for clients who own property jointly and want to continue this form of ownership.

ENDNOTES

1 The author gratefully acknowledges the wonderful assistance of attorney Janet Rae Montgomery in the preparation of this article.

2 One theme is that the use of the joint trust in a second marriage situation, in which one spouse comes into the marriage with kids from a prior marriage, is very difficult. The author advocates staying away from this use of the joint trust until such time as the issues pertinent to that special situation are worked out in more detail.

3 The ability of one spouse to deal separately with his or her "separate" property—to buy, sell or otherwise change the form of the investment—or to change his or her estate plan without the consent of the other spouse, is adversely impacted by a joint trust. Clearly, a joint trust should only be used in stable first marriage situations—and this caution remains true today. If anything, trying to maintain separate shares inside a joint trust increases complexity and administrative costs rather than simplifying anything.

4 "It is well known that the unified credit of the first spouse to die will be wasted if all assets are owned in joint tenancy with rights of survivorship. It would be surprising if a joint trust did not raise similar estate tax problems as the price for being consistent with the desire of many spouses to own all assets jointly." Robert M. Bellatti, *Farm Estate and Trust Planning and Administration: Joint Trust Transfer Tax Traps*, 21st Annual Notre Dame Tax and Estate Planning Institute (1995), at 13-6.

5 We live in troubled times.

6 LTR 200101021 (Oct. 2, 2000).

7 Reg. §25.2523(e)-1(f)(6).

8 If the surviving spouse is the grantor of the trust created for the surviving spouse's benefit at the first spouse's passing, this would create Code Sec. 2036 concerns, and that trust would be includable in the surviving spouse's gross estate at his or her passing.

9 *See, e.g.*, LTR 9026036 (Mar. 28, 1990).

10 In support of this position, the IRS cites the legislative history of Code Sec. 1014(e)—*see* H.R. REP. NO. 97-201 (1981). The legislative history talks about indirect return in the form of a gift that increases the marital deduction in the donor spouse's estate:

> The denial of a stepped-up basis applies where the donor receives the benefit of the appreciated property regardless of whether the bequest by the decedent to the donor is a specific bequest, a general bequest, a pecuniary bequest, or a residuary bequest. However, in the case of a pecuniary bequest, the donor will receive the benefit of the appreciated property only if the inclusion of the appreciated property in the estate of the decedent affected the amount that the donor receives under a pecuniary bequest.

11 John H. Martin, *The Joint Trust: Estate Planning in a New Environment*, 39 REAL PROP. PROB. & TR. J. 275 (2004).

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