Tax Considerations for Estate Planning with Trusts

By Justin W. Whitney

I.

Introduction

A trust is the centerpiece of many estate plans. Tax planning for the use of a trust requires an understanding of individual income taxation, fiduciary income taxation and estate taxation. This paper is intended to provide a guide to practitioners contemplating these issues and with an emphasis on the relevant statutes, treasury regulations, Kansas case law and IRS Private Letter Rulings that should be consider when incorporating a trust into an estate plan.

II.

Common Estate Planning Techniques

A. Pour-over Will with Revocable Trust

1. Basic Plan

Irrespective of the design, most clients plan to avoid the burdens associated with administering their estate through the commencement of a probate case. Instead, these clients seek what are known as "will-substitutes" which are instruments and arrangements that transfer their assets automatically upon their death by operation of law without a formal conveyance document or an order from a probate court. Common will-substitutes include joint tenancy bank accounts, qualified retirement plans, life insurance policies and transferable on death accounts.

Likely the most common will-substitute is the inter-vivos revocable trust sometimes called a living trust. A trust is an instrument wherein the grantor transfers legal ownership of property to a trustee.[1] At the same time, the grantor or beneficiaries of the trust are the equitable owners of the trust property.[2] In Kansas, a trust instrument has the following features:

> (1) An explicit declaration and intention to create a trust; (2) the transfer of lawful and definite property made by a person capable of making transfer thereof; and (3) a requirement to hold [the property] as trustee for the benefit of a cestui que trust with directions as to the manner in which the trust funds are to be applied.[3]

The trustee owes a fiduciary duty to manage the property held in the trust for the benefit of the trust beneficiaries.[4] Under Kansas Law, a revocable trust can be funded by a formal conveyance instrument such as a deed or assignment; or by grantor making a written declaration that certain property shall be held in trust.[5] Typically, a grantor will serve as trustee of their own revocable trust until a time when based on age and other circumstances, the grantor resigns as trustee and appoints a relative or professional to serve as successor trustee. Even though the grantor is no longer trustee, he or she generally retains the right to revoke the trust. When the grantor dies, the trust becomes irrevocable by operation of law. The successor trustee is then charged with distributing the trust assets to the trust beneficiaries in accord with the terms of the trust. The trustee is authorized to administer and terminate the trust without court supervision.

---

[1] Restatement Second of Trusts § 2 (1959).

[2] Id.

[3] *Jennings v. Jennings*, 211 Kan. 515, Syl. P 4, 507 P.2d 241 (1973).

[4] K.S.A. § 58a-105(b)(3).

[5] *Taliaferro v. Taliaferro*, 260 Kan. 573, 577 (Kan. 1996) (“"[a] trust may be created by (a) a declaration by the owner of property that he holds it as trustee for another person; or (b) a transfer inter vivos by the owner of property to another person as trustee for the transferor or for a third person.").

Over the course of the grantor's life, the grantor can convey some or all of his or her assets to the trust. If the grantor transfers all of his or her assets to the trust so that he or she dies owning only minimal assets, then it will be unnecessary to commence a probate lawsuit in order to transfer the grantor's assets to the beneficiaries. At the time of drafting a revocable trust, a "pour-over will" is executed which provides that any assets owned by the grantor at death are to be conveyed by the probate court to the trust. If the grantor dies, owning substantial assets, then the grantor's will catches those assets and pours the assets over to the trust.

2. Tax Consequences

(a) Initial Creation of the Revocable Trust

Executing and funding a revocable trust generally will not immediately cause a change in a client's tax circumstances. This is because a revocable trust constitutes what is known under the Internal Revenue Code ("I.R.C.") as a grantor trust. 26 CFR 1.671-4(b)(1) provides that if a settlor is trustee of a grantor trust, all trust income can be reported on form 1040 and completing form 1041 is not required. A grantor trust is a trust that is deemed to be owned by an individual grantor or beneficiary under I.R.C. §§ 671-679. I.R.C. § 673(a) sets forth the general rule that a "grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion." I.R.C. 674(a) provides with certain exceptions that the grantor shall be treated as the owner of any portion of a trust for which he may exercise a power of appointment. I.R.C. 675 provides that the grantor shall be treated as the owner of any portion of a trust in which he may exchange or dispose of the corpus or income for less than adequate consideration. I.R.C. 676(a) states that a grantor shall be treated as the owner of any portion of a trust "where at any time the power to re-vest in the

grantor title to such portion is exercisable by the grantor or a nonadverse party, or both." Spouses are treated as a single grantor if they are both U.S. Citizens or residents.[6] Thus, a revocable trust established by a husband and wife as grantors will result in both spouses being treated as the deemed owners of all the income and assets related to the trust for federal income tax purposes.[7]

(b) Tax Implications when the Grantor Dies

A revocable trust becomes irrevocable upon the death of the grantor. As an irrevocable trust, the trust no longer qualifies under the taxation rules proscribed for grantor trusts. Instead, other portions of Subchapter J of the I.R.C. will govern the tax consequences. An irrevocable trust with any taxable income or gross income exceeding $600 is required to file a tax return using IRS Form 1041.[8] Income arising from an irrevocable trust is in most circumstances taxed to the recipient of the taxable income. In other words, if taxable income is retained by a trust rather than distributed to the beneficiaries, the trust will generally pay tax on that income. Generally speaking, if a trust makes a distribution to beneficiaries, some or all of that distribution may be taxable to the beneficiaries depending upon whether the trust had "distributable net income" ("DNI") for the tax year.[9] When the beneficiaries receive a taxable distribution, the trust is usually allowed a deduction for an equal amount to prevent taxing the

---

[6] 26 CFR 1.1361-1(e)(2).

[7] 26 CFR 1.671-4(b)(1) provides that if a settlor is trustee of a grantor trust, all trust income can be reported on form 1040 and completing form 1041 is not required. The grantor's social security number will serve as the Federal Entity Identification Number for a revocable trust.

[8] I.R.C. § 6012(a)(4).

[9] See I.R.C. § 662(a). I.R.C. § 643(a) sets forth the definition of DNI and § 643(b) defines "income" to mean fiduciary income under local law.

same income twice.[10] If a trust has DNI in a tax year and makes a distribution to beneficiaries, the distribution will be taxable to the recipients only to the extent of DNI.[11] The balance of the distribution constitutes a tax free return of trust corpus[12] or income previously taxed to the trust.

As explained above, the extent to which a trust has DNI in a tax year will dictate the tax consequences to the beneficiaries of distributions from the trust.[13] DNI in a given year is essentially the taxable income of the trust plus the personal exemption otherwise available to the trust and with adjustments to remove capital gains and losses and tax exempt income from DNI.[14] Income to a trust is generally taxed consistent with how income to an individual is taxed.[15] However, the calculation of DNI incorporates the trust's fiduciary accounting income which is governed by state law and the terms of the trust.[16] Fiduciary accounting rules may provide for example that capital gains are allocated to the principal portion of the trust property and therefore do not constitute income of the trust in a fiduciary accounting sense even though a capital gain would result in taxable income under federal tax law.[17] Trustees are restricted by state law and the trust instrument when deciding how to distinguish between income and

---

[10] See I.R.C. § 661.

[11] I.R.C. § 662(a).

[12] Under I.R.C. § 102(a) and (b) a gift of property to a trust does not constitute income to the trust as opposed to income generated by such property which does constitute taxable income to the trust.

[13] Subchapter J distinguishes between simple trusts and complex trusts.[13] A trust is characterized as simple in a given year if it must by its terms distribute all of its income Applicablely, cannot have charitable beneficiaries and does not distribute principal. If the trust is not simple, then it is complex. A beneficiary of a simple trust, as opposed to a complex trust, must include their share of DNI in gross income even if there are no distributions from the trust. See I.R.C. §§ 651, 652, 661 and 662.

[14] See I.R.C. § 643.

[15] See I.R.C. § 641(b).

[16] I.R.C. § 643(b).

[17] See K.S.A. § 58-9-101, et seq.

principal for purposes of honoring the trust terms regarding distributions due to beneficiaries. By incorporating fiduciary accounting income into DNI, Subchapter J generally imposes the burden of the income taxes generated by the trust upon an individual beneficiary only to the extent the beneficiary receives a distribution from the trust.[18] DNI is allocated to beneficiaries according to tiers. Beneficiaries holding an enforceable right to income share in the first tier of DNI pro rata.[19] Beneficiaries holding only a discretionary right to income are allocated any remaining DNI that is not absorbed by first tier beneficiaries.[20] In most circumstances, when a trust makes a distribution to its beneficiaries, the trust is afforded a deduction to the extent of the trust DNI for that year.[21]

(c) Issues Presented by Low Basis Property

In light of the potential under Subchapter J for a trust or the beneficiary to be taxed on a capital gain when trust corpus is sold, it is important to consider the basis of property transferred to a trust and the potential for basis to change at the grantor's death. When property is conveyed intervivos to a revocable grantor trust, there is no distinction for tax purposes between the grantor and the trust and therefore if the property is sold prior to the trust becoming irrevocable, gain or loss on the sale will be calculated by reference to the grantor's adjusted basis.[22] If the

---

[18] If the trust instrument excludes a capital gain from the definition of income, the practical result is that the capital gain will be included in the trust's taxable income but will not be included in DNI. Distributions in that year to the beneficiary will only be taxable to the extent of DNI and thus the beneficiary will not be taxed on the capital gain, rather the capital gain will be taxed to the trust and will not be offset by the DNI deduction available to the trust.

[19] I.R.C. §§ 652(a) and 662(a).

[20] I.R.C. § 662(a).

[21] See I.RC. §§ 651(a), 661(a) and 663(a)(1). I.R.C. § 663 sets forth the specific bequest rule which provides that a distribution in satisfaction of a specific bequest does not result in taxable income to the beneficiary or create a deduction for the trust.

[22] See I.R.C. § 1012.

revocable trust still owns the property at the time of the grantor's death, the revocable trust receives a step-up in basis to fair market value of the property at the grantor's death.[23] If a grantor makes a completed gift to an irrevocable trust during the grantor's life, the irrevocable trust will take a carryover basis from the grantor under I.R.C. § 1015. The distinction in treatment of basis under I.R.C. §§ 1014 and 1015 is noteworthy. Under the right circumstances[24], the decision to utilize a revocable trust, as opposed to an irrevocable trust, to transfer low basis property at the grantor's death may reduce the capital gains taxes imposed on the trust or the beneficiaries because assets held by the revocable trust are eligible for a step-up in basis to fair market value upon the death of the grantor under I.R.C. § 1014(b)(9).

The timing for recognizing gain on appreciated trust property is elective under I.R.C. § 643(e). Under that subsection, a beneficiary taking an in kind distribution of trust property takes the trust's carryover basis unless the trust elects to recognize gain when the property is distributed by treating the property as being sold for its fair market value. If appreciated property is transferred to satisfy a pecuniary obligation of the trust, the transfer is treated as a sale.[25]

(d) Consequences of Funding a Trust with Qualified Retirement Plans

Practitioners should tread carefully when considering whether to convey ownership of a tax qualified retirement plan to a revocable trust or to name such trust as beneficiary of the retirement plan. The genesis of this concern is that improper mixing of a trust and a tax qualified retirement plan has the potential to expedite the deadlines for which a beneficiary of such account must begin taking a Minimum Required Distribution ("MRD") or else be subject to a

---

[23] See PLR 200210051 and PLR 200101021.

[24] Generally, a revocable trust would be preferable to an irrevocable trust where a client has appreciated property and has a taxable estate less than the Applicable Exclusion Amount.

[25] 26 CFR 1.661(a)-2(f)(3).

50% tax penalty.[26] Retirement plans with tax deferred features must begin distributing plan funds to the employee or plan owner generally beginning at age 70.5.[27] A tax-deferred retirement plan means a plan that is tax qualified within the meaning of I.R.C. § 401(a) or an individual retirement account ("IRA") within the meaning of I.R.C. §§ 408 and 408A. The MRD is the distribution required by I.R.C. § 401(a)(9).[28] The MRD is calculated using a life expectancy factor based on the age of the employee or plan owner.[29]

One of the beneficial features of a qualified retirement plan is that the investments therein can grow and accumulate earnings income tax deferred which permits the earnings to grow at a faster rate than if the investments were saddled with Applicable income tax on capital gains, interest and dividends. Thus, prolonging the period wherein the investment can grow tax deferred will generally result in a larger asset value for the beneficiary than if the account becomes subject to income tax shortly after a decedent dies. The regulations governing MRDs provide for longer deferral opportunities if an individual is the beneficiary of a retirement plan as opposed to a legal entity such as a trust.[30]

The consequence of naming a trust as the beneficiary of a retirement plan can, without careful drafting consideration, reduce the size of the asset that a decedent is ultimately able to

---

[26] I.R.C. § 4974(a).

[27] I.R.C. § 401(a)(9).

[28] Regulations governing MRDs are located at 26 C.F.R. 1.401(a)(9)-0 to 1.401(a)(9)-9, 1.403(b)-6(e)(2), 1.408-8, and 54.4974-2. Regulations under I.R.C. § 401(a)(9) are applicable to Individual Retirement Accounts ("IRAs") by virtue of I.R.C. § 408(a)(6) and to I.R.C. § 403(b) plans by virtue of I.R.C. § 403(b)(10). Simplified employee pensions ("SEP") as defined by I.R.C. § 408(k) and SIMPLE IRAs as defined by I.R.C. § 408(p) are subject to the regulations under I.R.C. § 401(a)(9) by virtue of 26 C.F.R. 1.408-8, A-2.

[29] 26 CFR 1.401(a)(9)-5, A-1(a).

[30] I.R.C. § 409(a)(9)(E)(designated beneficiary status is limited to "any individual designed by the beneficiary by the employee."). If a non-individual is the beneficiary of a qualified plan, the benefits generally must be distributed within five years to avoid the 50% penalty as opposed to the life expectancy of a natural person beneficiary. See 26 C.F.R. 1.401(a)(9)-4, A-3.

pass to his or her chosen beneficiary and; potentially result in malpractice for the estate planning attorney. For example, consider a client with a $1,000,000 IRA account who intends to leave the entire account to his only child. The client dies when the child is age 30. The child does not need the account for living expenses and would prefer that the account remain invested and grow as large as possible. If the client had been advised to designate his child as the designated beneficiary of the account then at client's death, then the child will be subject to lower annual MRDs which are calculated with the aim of distributing the account evenly over the child's life expectancy.[31] As a result, much of the account can remain in tax deferred status for the rest of the child's life; meaning the account can grow faster than if the earnings were taxed. If the client had been advised to select a trust as the designated beneficiary of the account, then the account must be fully distributed over five years or else be subject to a 50% penalty.[32] Under this scenario, when the account is fully distributed to the child, no portion of the account can grow tax deferred meaning that the account will grow slower over time. The end result is that client's child receives less money than if client had been properly advised.

B. Disclaimer Trust

1. Planning for the Estate Tax

I.R.C. § 2001 imposes a 40% tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. However, I.R.C. § 2010(a) provides a tax credit ("Unified Credit") for individuals dying in 2014 which has the effect of excluding up to $5,340,000 ("the Applicable Exclusion Amount") from such decedent's taxable estate. Consequently, there is no estate tax due on a taxable estate valued at less than $5,340,000.

---

[31] 26 C.F.R. 1.401(a)(9)-5.

[32] 26 C.F.R. 1.401(a)(9)-4, A-3.

Furthermore, a surviving spouse can utilize the unused portion of the deceased spouse's Applicable Exclusion Amount so that estate tax is not imposed unless the couple's total estate exceeds $10,680,000. Only a small portion of U.S. citizens will ultimately be subjected to federal estate tax. For this reason, consideration of tax basis in trust assets will often be more relevant to tax planning that consideration of the estate tax. Nonetheless, laws can change and a solid estate plan should be flexible enough to address the potential for estate tax liability.

2. Is a Credit Shelter Trust Appropriate?

The purpose behind a credit shelter trust is to ensure that the first spouse to die does not underutilize his or her Unified Credit thereby wasting it and leaving the surviving spouse with a taxable estate larger that is too large to be shielded from estate tax using only the surviving spouse's Unified Credit. This scenario is possible because I.R.C. § 2056 provides that the taxable estate shall be reduced by an amount equal to the value of testamentary transfers by the decedent to a surviving spouse ("the Marital Deduction"). For example, consider a husband that dies with a taxable estate of $10,680,000 and bequeaths his entire estate to his surviving wife. Prior to the advent of "portability"[33], if the wife dies three years later with a $10,680,000 taxable estate, her Unified Credit will only shield $5,340,000 from estate tax meaning that the remaining $5,340,000 will be subjected to estate tax.

To prevent the above described scenario, a couple with assets exceeding the Applicable Exclusion Amount would consider an estate plan that intentionally includes within the taxable estate of the first spouse to die an amount of assets equal to the Applicable Exclusion Amount and then bequeaths those assets to someone other than the decedent's spouse such as the decedent's children in order to prevent triggering a martial deduction which has the consequence

[33] Under current law, a surviving spouse can preserve the Unified Credit of the decedent spouse by making a timely election at the death of the decedent spouse. See I.R.C. § 2001.

of tagging those assets for later inclusion in the surviving spouse's taxable estate.[34] For reasons apparent in the discussion below, this type of planning is sometimes referred to as "A-B Planning." When a revocable trust is involved in credit shelter planning, the trust provisions generally provide that upon the grantor's death, the trust becomes irrevocable and the trust corpus is allocated into two separate trusts. One trust is referred to as the credit shelter trust or bypass trust or B trust. The trustee allocates to this trust a portion of the corpus equal to the Applicable Exclusion Amount. The terms of the credit shelter trust provide that the corpus shall pass to beneficiaries other than the surviving spouse except that the surviving spouse during his or her lifetime can access the corpus for his or her health, education, maintenance and support. The credit trust ensures that the first to die's Unified Credit is fully utilized but still allows the surviving spouse limited access to the corpus. The balance of the trust assets are allocated into what is referred to as the marital trust or continuing trust or A trust. The assets conveyed to the marital trust qualify for the marital deduction thereby removing those assets from the decedent's taxable estate.[35] By virtue of the Unified Credit and the martial deduction, no estate tax will be due when the first spouse dies. When the surviving spouse dies, his or her taxable estate will include all of the assets owned at death, which will include those assets received under the marital trust unless consumed prior to death.

3. Disclaimer Trusts with A-B Planning

A-B Planning imposes additional administrative complexity that may not be appropriate in every situation. When planning the estate of an elderly couple with less than $1,000,000 in total assets, A-B Planning has the potential to cause more problems than it solves. This is

[34] I.R.C. § 2033 ("The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.").
[35] I.R.C. § 2056.

especially true in light of the portability provision now included in I.R.C. 2001. In situations where incurring estate tax is unlikely, A-B Planning will usually be unnecessary. However, a device known as a disclaimer trust[36] can create a safety hatch that is flexible enough to provide A-B Planning in the unexpected event that a couple's assets grow in excess of the Applicable Exclusion Amount. Under a disclaimer trust, at the death of the first spouse to die, all the corpus passes to a marital trust for the benefit of the surviving spouse which qualifies for the marital deduction meaning that none of these assets will be included in the taxable estate of the decedent. If the couples' assets are less than the Applicable Exclusion Amount, the end result is that no estate tax is due and the surviving spouse has complete access to the entire corpus of the original trust. As a backup plan, the trust will also include a provision for the establishment of a credit shelter trust which will receive a portion of the trust corpus on the condition that the surviving spouse disclaims her interest in the marital trust.[37] If at the time of the first spouse's death, the trust corpus exceeds the Applicable Exclusion Amount so that A-B Planning is necessary to reduce estate taxes, the surviving spouse can disclaim a portion of the corpus that would otherwise pass to the marital trust. By exercising the disclaimer, assets exceeding the Applicable Exclusion Amount are transferred to the credit shelter trust.

(a) Relevant Private Letter Rulings

When considering the tax consequences of an estate plan, if relevant case law is not available, a practitioner may find helpful guidance in what is known as a private letter ruling

---

[36] See Martin, John H., The Joint Trust: Estate Planning in a a New Environment, 39 Real Prop. Prob. & Tr. J. 275, 285 -87 (2004) ("The Disclaimer Joint Trust allows the estate planner to use the Basic Joint Trust format, but to hedge by including a safety net that can be unfurled if later circumstances disclose the need for a shelter arrangement.").

[37] See Martin, p. 303 at Form 4.

from the IRS. A private letter ruling is not binding precedent.[38] However, private letter rulings do provide an indicator of how the IRS is likely to view a legal issue in the future. As part of the research for this paper, a case law search was performed in order to find guidance on how the step-up in basis provisions of I.R.C. § 1014 have been interpreted in the context of a joint trust. A LexisNexis search of all reported federal court cases, including tax court cases, that contained the search terms "joint trust" and I.R.C. § 1014 produced zero results. However, a search of the private letter ruling database produced two highly relevant private letter rulings which are discussed below. In light of the absence of federal case law addressing the subject, these two private letter rulings represent the latest and most relevant guidance on the subject.

1. PLR 200101021

In Priv. Ltr. Rul. 200101021, husband and wife grantors sought a ruling with regard to the tax consequences of a joint trust. The joint trust was funded with property that they owned as tenants by the entireties.[39] During their joint lives, either grantor had the power to terminate the trust and cause the trust property to return to the grantors who would then own such property as tenants in common. [40] Pursuant to the trust terms, at the death of the first spouse to die, the deceased spouse shall hold a testamentary general power of appointment over all of the trust assets.[41] If the general power of appointment is not exercised, then the trust provided as follows:

> [A]n amount of Trust property sufficient to equal the largest amount that can pass free of federal estate tax by reason of the unified credit, is to be transferred to an

[38] I.R.C. § 6110(k)(3)(2000).

[39] Priv. Ltr. Rul. 200101021, 2000 PLR Lexis 1792, * 1-2. Private Letter Rulings do not serve as precedent pursuant to I.R.C. § 6110(k)(3).

[40] Id.

[41] Id.

> Irrevocable Credit Shelter Trust. Any amount in excess of the amount needed to fully fund the Credit Shelter Trust that has not been appointed by the deceased Grantor will pass outright to the surviving Grantor.[42]

The IRS ruled that the contribution of jointly owned assets to the trust did not constitute a completed gift by either grantor because each grantor retained a unilateral right to revoke the transfer causing title to revest in themselves.[43] Each grantor was permitted to terminate the trust and receive 50% of the entire trust corpus. Based on that fact, the IRS found that a distribution of property from the trust to one spouse alone during the existence of the trust would be considered a gift to that spouse from the other spouse equal to 50% of the value of the distribution.[44] This gift would qualify for the marital deduction pursuant to I.R.C. § 2523.[45] At the death of the first spouse to die, the retained control by that spouse over 50% of the trust property caused 50% of the trust property to be included in the deceased spouse's gross estate under I.R.C. § 2038. Keep in mind, the trust terms also provided that the deceased spouse held a testamentary general power of appointment over 100% of the trust assets. As a result, 100% of the trust assets were included in the deceased spouse's gross estate for estate tax purposes under I.R.C. § 2041.[46] When the first spouse dies, the surviving spouse is deemed to have lost dominion and control over Trust corpus and therefore is treated as having made a completed gift to the deceased spouse for an amount equal to 50% of the value of the trust corpus.[47] This gift also qualifies for the marital

---

[42] Id at * 3.

[43] Id at * 8-9. Support for this conclusion was based upon 26 C.F.R. 25.2511-2(b) and (c) which provide that a gift is complete when the donor has no power to change the disposition of the gift and incomplete when a donor reserves the power to reacquire title to the gifted property.

[44] Id at *9.

[45] Id.

[46] Id at * 9-10.

[47] Id at * 10.

deduction but is also subject to I.R.C. § 1014(e) which prevents a step-up to fair market value basis for appreciated property acquired by a decedent within one year of death that passes to the donor at the death of the decedent.[48] Consequently, only one-half of the trust corpus was eligible for a step-up in basis at the death of the first deceasing spouse under I.R.C. § 1014(b)(9).[49]

2. PLR 200210051

In Priv. Ltr. Rul. 200210051, husband and wife grantors contributed property to a trust that they held as joint tenants with rights of survivorship.[50] During their joint lives, either spouse had the power to revoke the trust causing all property to returned to the spouses.[51] Upon the death of the first spouse to die, the trust divided as follows:

> [A]n amount of Trust property equal to the maximum marital deduction allowable to the deceased spouse's gross estate reduced by the amount necessary to create the largest taxable estate, which after utilizing the unified credit, will result in no tax due is to be transferred to a Marital Trust. During the life of the surviving spouse, the trustee(s) shall pay the net income to the surviving spouse at least quarter-Applicablely, and such amounts of principal as the surviving spouse may direct. Upon the death of the surviving spouse, the trustee(s) shall pay over any remaining principal to such persons that the surviving spouse shall appoint by his or her Last Will. . . . [T]he remaining balance of Trust property is to be placed in a Family Trust. During the life of the surviving spouse, the trustee(s) is to pay all the net income to the surviving spouse. The trustee(s) may also pay so much principal allocated to the Family Trust to or for the benefit of surviving spouse and the issue of both Donors, as the trustee(s) shall deem advisable for their health, support, maintenance, or education. Upon the death of the surviving spouse, the remaining income and principal in the Family Trust shall be distributed to the Donor's living issue per stirpes.[52]

---

[48] Id.

[49] Id at * 10-11.

[50] Priv. Ltr. Rul. 200210051, 2001 PLR LEXIS 1945, * 1.

[51] Id.

[52] Id at * 3-5.

In evaluating the tax consequences of the trust, the IRS found, consistent with the ruling from PLR 200210051, that the portion of the trust corpus transferred to the trust by the first spouse to die would be includible in his or her estate by virtue of I.R.C. § 2038 and the portion of trust corpus transferred to the trust by the surviving spouse would be includible in the estate of the first spouse to die by virtue I.R.C. § 2041 because that spouse held a general power of appointment over all of the trust corpus.[53] The IRS also found, consistent with PLR 200210051, that the property contributed to the trust by the surviving spouse constituted a completed gift to the decedent spouse at the date of the first spouse's death and was not eligible for a basis step-up under I.R.C. § 1014(e). [54]

3. <u>Planning Opportunities based on PLR 200210051 and PLR 200101021</u>

From a planning standpoint, consider how the results of PLR 200210051 and PLR 200101021 could be changed if during his or her life, the deceased spouse had the ability to reacquire title to 90% of the trust assets rather than 10%. The analysis from both of the PLRs discussed above would suggest that only 10% of the trust assets constituted a completed gift from the surviving spouse at the time of death of the deceased spouse. As a result, only 10% of the trust assets would be subject to I.R.C. § 1014(e) and 90% of the trust assets would be eligible for a step-up in basis under I.R.C. § 1014(b)(9). In a situation where clients have low basis assets and where one spouse is significantly older than the other, it might be appropriate to draft a trust that provides the older spouse with the ability to withdraw most or all of the trust assets during his or her lifetime. This planning strategy could allow 90% of the assets to experience a step-up in basis at the time of the death of the first spouse and therefore minimize capital gains taxes.

[53] Id at * 8.

[54] Id * 9-10.

Alternatively, instead of drafting the trust to give one spouse the ability to withdraw most of the assets, the trust terms could provide that each spouse could withdraw from the trust all of the property that was owned by such spouse separately before it was contributed to the trust. Spouses could make tax free gifts between themselves[55] prior to funding the trust so that one spouse ultimately contributes most of the assets to the trust. If that spouse is ultimately the first to die, those assets will receive a step-up in basis to fair market value under I.R.C. § 1014(b)(9).

When making planning decisions, it is important to note that the joint trusts at issue in both PLRs discussed above became irrevocable with regard to all trust assets when the first spouse died. Such a trust provision assures that at least some of the assets in the trust will not receive a basis step up in light of I.R.C. § 1014(e). Perhaps the better planning decision is for each spouse to have his or her own separate revocable trust that is funded with his or her separate property. Under that strategy, none of the marital estate would lose its basis step-up to I.R.C. § 1014(e) because each spouse would retain control over his or her revocable trust until death.

(b) When Should a Joint Revocable Trust Become Irrevocable?

When designing an estate plan for a married couple which incorporates a trust, one could consider three possibilities. The first scenario is that each spouse has his or her own separate trust. The drawback to this model is that the clients have twice as much paperwork to read and sign. Furthermore, questions arise as to which of their jointly held assets should be conveyed to which trust. The second scenario, and that contemplated by PLR 200101021 and 200210051 is that the married couple utilize a joint revocable trust that becomes irrevocable upon the death of the first spouse. A third scenario is the use of a joint revocable trust that does not become irrevocable until the death of the surviving spouse. The common law contemplates that a joint

[55] These gifts would qualify for the maritial deduction under I.R.C. § 2523.

trust could remain revocable until the death of the surviving spouse if both spouses intended that result. The Restatement Third of Trusts provides that a revocable trust with multiple grantors becomes irrevocable upon the death of the first spouse to die with regard to the assets contributed by the deceased spouse. The Restatement states:

> Following the death of one of them, the trust becomes irrevocable and unamendable as to the portion of the trust traceable to the decedent's contributions, with the survivor having power to revoke or amend with respect to the rest of the trust--i.e., only with respect to the part traceable to the survivor's contributions. (If a different result is intended, the settlors should expressly so provide; but even if they have failed to do so, the vague language quoted above concerning revocation and amendment may be clarified by extrinsic evidence showing the intended terms of the trust on this matter.)[56]

This issue was addressed by the New Mexico Supreme Court in the case of *Cable v. Wells Fargo Bank N.M., N.A.*[57] In *Cable*, husband and wife grantors executed a joint trust which was permitted to be revoked "during their joint lifetimes."[58] Following the death of the first spouse, the surviving spouse amended the trust to change the beneficiaries.[59] When the surviving spouse died, a beneficiary whose share was reduced as a result of the later amendments sued Wells Fargo Bank as trustee arguing that the amendments were contrary to the terms of the trust.[60] The New Mexico Supreme Court found the grantors expressly intended that the trust would remain revocable until the last of them died. The Court stated:

---

[56] Restatement 3d of Trusts § 63.

[57] 148 N.M. 127, 131 (2010).

[58] Id.

[59] Id at 128.

[60] Id at 128-129.

> [W]e conclude that the documentation reflects an overarching intent to create a trust that would (1) provide for both Lowell and Martha, with the power to amend or revoke its provisions during their joint lifetimes; (2) provide for the needs and wishes of the surviving spouse, with the same power to amend or revoke after the death of the first of them; and (3) convey any remaining assets in the trust estate to other beneficiaries after the deaths of both spouses.[61]

Neither the Kansas Supreme Court nor the Kansas Court of Appeals have addressed this issue. It seems plausible that the Kansas Supreme Court would adopt the *Cable* rational and give effect to a joint trust that was intended to remain revocable until the last of the grantors dies. The tax consequences of such a trust would be similar to the outcomes in PLR 200101021 and 200210051. If the first spouse to die held a general power of appointment over the trust corpus but failed to exercise the power at death, then under the logic of the above mentioned private letter rulings, the trust corpus would be included in the estate of the first spouse to death under I.R.C. § § 2038 and 2041. The decedent spouse's failure to exercise the power would cause the surviving spouse, as taker in default, to receive the entire trust corpus outright. No estate tax would be incurred on the transfer of the trust corpus outright to the surviving spouse because the transfer would qualify for the marital deduction. The trust corpus would be included in the surviving spouse's gross estate under I.R.C. § 2041. Property in the trust which was contributed to the trust by the decedent spouse and by the surviving spouse would likely receive a step-up in basis under I.R.C. § 1014(a).

Not all planning considerations are tax motivated. A joint trust that is revocable even after the first spouse is deceased might not be appropriate for a husband and wife that are in a second marriage and have children from another marriage. This is because the surviving spouse will have the ability to withdraw 100% of the trust assets after the first spouse dies creating the possibility that nothing is available to the decedent spouse's children. To avoid that possibility,

[61] Id at 131.

each spouse may prefer to have their own separate revocable trusts funded with separate assets. On the other hand, an elderly couple that has been married their entire lives and only have children with each other would be ideal candidates for a joint trust that becomes irrevocable when the surviving spouse dies.

3. Considerations Relative to Spendthrift Beneficiaries

When a trust is a component of the estate plan, it is worthwhile to consider the nature of the rights of the beneficiaries to access the trust property. Kansas law makes a distinction between vested rights and a mere expectancy. Will-substitutes such as a beneficiary designation in a retirement plan, a beneficiary of a TOD account or a beneficiary under a revocable trust constitute only a mere expectancy as opposed to a vested right. This distinction is warranted because the interest can be divested by depletion, revocation or by changing the beneficiary.[62] On the other hand, a beneficiary's interest in an irrevocable trust would be considered a vested right.

This concept was highlighted in the Kansas bankruptcy case of In re *Hall.*[63] In that case, the beneficiary's father died 18 days after Linda Hall filed a Chapter 7 bankruptcy case. Her father's death entitled her to receive certificates of deposit, real estate, bonds, life insurance proceeds, and an IRA by virtue of her status as a payable on death beneficiary.[64] If Hall's interest in these assets was a vested right, then the assets would be available to pay her creditors in bankruptcy as property of the bankruptcy estate. The court in *Hall* expressly held that an

---

[62] In re *Hall,* 441 B.R. 680, 689-691 (10th Cir. BAP Dec. 4, 2009).

[63] 441 B.R. 680 (10th Cir. BAP Dec. 4, 2009).

[64] Id at 681.

expectancy interest is not property of the bankruptcy estate even the right becomes vested during the 180 day period following the filing date.[65] The Court stated:

> POD accounts, TOD accounts, and TOD deeds, as well as revocable inter vivos trusts, are all devices frequently utilized in estate planning as "will substitutes". Further, interpretation of the terms "bequest, device, and inheritance" to include only property passing pursuant to will or intestate succession, but not other more modern methods of transferring property on death, may appear to exalt form over substance. However, we are required to presume congress intended for the courts to apply the plain language of the statute unless such interpretation would lead to an absurd result.[66]

There is also case law in Kansas providing that a beneficiary's rights under an irrevocable trust could be excluded from property of the bankruptcy estate if the trust contains a valid spendthrift clause.[67]

The planning lesson from *Hall* is that a client should carefully consider whether the beneficiary of the client's estate may face collection efforts from creditors. If so, the use of transfer instruments that are mere expectancies such as a revocable trust is ideal because the assets are not reachable by the beneficiaries' creditors. However, as mentioned below, there are often reasons that an irrevocable trust is chosen as the primary estate planning instrument. If an irrevocable trust is used, the beneficiary is treated as having a vested right to the trust assets. To prevent the vested right from being attacked by creditors, it is important to make sure the irrevocable trust contains a spendthrift clause. A typical spendthrift provision provides:

---

[65] Id at 691 ("We agree with the Bankruptcy Court that whatever rights L. Hall had in the Assets as of the petition date are not legal or equitable interests in property as contemplated by § 541 (a)(1). Rather, we view them as more akin to a mere expectancy. This is because any claim L. Hall had to the Assets was subject to divestment at any time during her father's life in a myriad of ways, including depletion, transfer, assignment, and change of beneficiary.").

[66] Id at 689.

[67] See In re *Robben*, 502 B.R. 572 (Bankr D. Kan. Dec. 17, 2013); In re *Roth*, 289 B.R. 161 (Bankr. D. Kan. Feb. 10, 2003).

Spendthrift Provision. It is Grantors' intent that a material purpose of this Trust is the preservation of the Trust Estate from mismanagement by an immature or imprudent beneficiary or attachment by any creditor, or any other claim, of any beneficiary. Therefore, the Trustee has absolute and sole discretion to withhold any distribution to any beneficiary in the event that the Trustee believes such beneficiary to be an immature or imprudent beneficiary or such distribution would be subject to attachment by any creditor, or any other claim and retain such share in trust until such time as the Trustee believes the threat of mismanagement is removed.

B. Intervivos Gifts to an Irrevocable Trust

1. Basic Plan

A lifetime gift to an irrevocable trust might be an appropriate strategy for someone that wishes to make an immediate gift of property that is appreciating in value, rather than at his or her death, so that the gift taxes on the transfer are based upon the present value and the recipient of the lifetime gift can benefit from the appreciation in the property free of gift or estate tax. This strategy is sometimes known as a "value freeze" and can be accomplished through the use of an irrevocable trust. Under this strategy, presume that a 40 year-old unmarried grantor with two children wants to transfer assets to the children and is contemplating whether to make the transfer currently to an irrevocable trust or to retain control of the assets using a revocable trust that will not become irrevocable until the grantor dies.

2. Gift and Estate Tax Consequences

The critical distinction between a lifetime transfer to an irrevocable trust and a revocable trust is that a transfer to an irrevocable trust will generally constitute a completed gift for gift tax purposes at the time of the transfer whereas a transfer to a revocable trust does not constitute a completed gift because the grantor retains the power until his or her death to revoke the trust.[68] A

[68] I.R.C. § 2511 and 26 CFR 2511-2.

lifetime gift to an irrevocable trust over which the grantor lacks dominion and control is subject to gift tax pursuant to I.R.C. § 2501(a). Gifts that are worth less than the Applicable Exclusion Amount will not result in the imposition of gift tax as a result of I.R.C. § 2505(a) which provides for a tax credit in an amount equal to the tax on the Applicable Exclusion Amount.[69] In most situations, property transferred by a completed lifetime gift will not be included in a decedent's taxable estate for gift tax purposes because the decedent no longer owns or retains control over the property.[70] On the other hand, property that is held in a revocable trust over which the grantor has the ability to exercise dominion and control (i.e. by revoking the trust) is included in the gross estate for estate tax purposes.[71] The effect of I.R.C. §§ 2501, 2033 and 2001 is to impose a single transfer tax at the time when property is irrevocably transferred whether by lifetime gift or testamentary bequest.

When appreciating property is transferred, electing to accelerate the transfer tax can result in less tax. Returning to the example above, presume that the grantor transfers $1,000,000 in 2015 to a revocable trust for the benefit of the children and that money grows at a rate of 12% per year and is accumulated rather than distributed. If the grantor dies 20 years later at age 60, the trust assets will be worth $9,646,293.[72] Assuming the Applicable Exclusion Amount remained at $5,340,000, then $4,306,293 would be subject to estate tax at a 40% tax rate

---

[69] It is important to note that the Unified Credit relative to estate tax pursuant to I.R.C. § 2010(a) is effectively reduced by the amount of the I.R.C. § 2505(a) credit that is utilized during a decedent's lifetime with intervivos gifts. See I.R.C. § 2001.

[70] See I.R.C. § 2033 ("value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death").

[71] I.R.C. § 2036.

[72] The future value of $1,000,000 compounded annually at 12% equals $ 9,646,293.

resulting in an estate tax of $1,722,517.[73] As a result of the estate tax, only $7,923,775 is available for distribution to the children whereas the full $9,646,293 could be distributed tax free to the children had the transfer tax been imposed 20 years earlier when the value was $1,000,000 and well below the 2015 Applicable Exclusion Amount. The downside is that the donor is forced to part with dominion and control of the property 20 years earlier.

III.

Conclusion

A trust is a flexible instrument for accomplishing estate planning objectives for both small and large estates. The tax issues presented above should be analyzed as part of developing a comprehensive estate plan. This paper is only a brief overview of the tax issues that can arise in estate planning and should not be considered as an exhaustive list. Every estate plan will be different based upon the client's unique goals and circumstances and will inevitably require consideration of unique tax consequences.

[73] $9,646,293 less 5,340,000 equals $4,306,293 multiplied 40% equals $1,722,517.