

# Drafting Joint Revocable Trusts

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*Joint revocable trusts can offer a conservative and a more risky way to step up basis.*

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**JOINT REVOCABLE TRUSTS** (joint trusts) have been used periodically by estate planners in common law property states in an effort to duplicate the income tax benefits available to married couples living in community property states. The Internal Revenue Code (Code) provides a large tax advantage to married couples living in community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.) At the death of the first spouse, the surviving spouse receives a full step-up in basis for not only the assets inherited from the decedent, but also for the surviving spouse's one-half share of community property held by decedent and the surviving spouse. Code §1014(a) and (b). (All section references are to the Code unless otherwise indicated.)

For example, two married couples each own real estate in their respective home states worth \$500,000, each having an income tax basis of \$100,000. Couple A lives in a common law state and Couple B lives in a community property state. The husband of each couple dies, leaving the wife surviving. Each wife inherits her husband's interest in the real estate. Wife A has an income tax basis in the real estate of \$300,000 (her original basis in one half of the property, \$50,000, plus the stepped-up basis in her husband's one half of the property, \$250,000), while Wife B has an income tax basis in the real estate of \$500,000.

Joint trusts have an appeal to many married couples because they have the same ownership connotations as joint tenancy. Most married couples are familiar and comfortable with the concept of joint ownership of their assets. Consequently, joint trusts have an intrinsic appeal to many married clients, but may be of limited practical value given the client's particular situation. However, the joint trust could be of significant value when preparing estate and business plans for the couple that owns a successful business. Although this article addresses the use of joint trusts in the family business context, the concepts should work equally well for any single low-basis, high-value asset.

**THE FAMILY BUSINESS** • Most estate planners who work with business owners will recognize the scenario: The couple began a business in their basement or garage. They develop a lucrative market for their product, and, over the course of their working years, create

a business of some value. As they approach their sixties and seventies, disposition of the business becomes an issue. Many of these couples will have adult children, some of whom are active in the business. These clients are usually interested in the best techniques for passing the business on to the next generation. This obviously raises many of its own issues and much has been written about family business succession planning and how to pass on a family business to the next generation, including the tax issues and the family relationship issues. However, there are situations in which a married couple either have no children, or have children who are, for one reason or another, uninterested and uninvolved in the business. At this point the couple acknowledges that because the lion's share of their estate is probably tied up in the business, they are interested in eventually disposing of the business. They begin searching for a way to extract their value from the business. The legislation regarding the family-owned business exclusion for estate tax is of no use to clients in this situation given the requirement that a family member or long-term employee continue operation of the business for 10 years to avoid the recapture rules. §2057.

Along with the emotional issues involved in the likely sale of a business that, for many, is like another child, come the financial issues of minimizing the tax consequences of a sale of business. In all likelihood, the couple's basis in the business is relatively small in comparison with its current value, particularly as a going concern. A sale of the business will likely result in significant capital gains. In this situation, a joint trust designed to own the client's business interest could be very useful. (A joint revocable trust is just one of several options available to such a client. Other options, aside from a straight sale to a third party, include a sale to an employee stock ownership plan and a gift to a charitable remainder trust).

Thus the ideal clients for a joint trust are a married couple who own a high-value, low-basis business, who intend to sell the business at some point but in all likelihood after the first death, and who have a good marriage such that divorce is unlikely. For these clients, transferring the business ownership to a joint trust can provide a full step-up in basis at the first death. Those assets allocated to the surviving spouse or a qualified trust for the benefit of the surviving spouse will receive a second step up in basis equal to the date-of-death value. §1014(a). (However, assuming the business interests are allocated between a marital trust and a credit shelter trust at the first death, there is some authority for the proposition that the Service may assert minority interest and lack of marketability discounts at the second death. *Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996). This will have the effect of reducing the extent to which the basis in the marital trust assets is stepped up at the second death.)

### **Setting Up The Trust**

Essentially, the idea is that the clients each contribute equal interests in the business to the trust (such as 50/50 ownership in stock of their corporation). The full value of the trust assets, that is, the full value of the business as a going concern, is included in the estate of the first spouse to die. The business interests can be allocated between a marital trust and a credit shelter trust. Both trusts are available for the benefit of the surviving spouse. The surviving spouse can act as a trustee of both trusts and thereby maintain some control over the business.

The surviving spouse (via the trusts) receives a full step-up in basis, not only for the interest of the deceased spouse, but also for the interest of the surviving spouse.

If drafted properly, the trust assets qualify for the unlimited marital deduction, and therefore, there is no estate tax due at the first death. The surviving spouse (again, via the trust) receives a full step-up in basis in the business, and therefore only realizes taxable gain at the sale of the business on the increase in value after the date of death. Obviously, the sale proceeds of the business interest are allocated to a marital trust for the benefit of the surviving spouse, and the surviving spouse's other assets, including other marital trust assets, will be included in the estate of the surviving spouse. Therefore, estate tax will be due at the death of the second spouse, if the value of the surviving spouse's assets, including all assets received from the deceased spouse, exceed the then available unified credit equivalent. (The unified credit against gift tax is \$1 million and, for decedents dying after 2001, the unified credit against estate tax is \$1 million for 2003, \$1.5 million for years 2004 and 2005, \$2 million for years 2006 to 2008, \$3.5 million for 2009, and non-existent in year 2010. Conventional wisdom has it that the unified credit against estate tax returns to \$1 million for decedents dying in years after 2010. §2010(c)).

Although such a joint trust has the potential to be extremely useful, it is full of potential traps. Very careful attention must be paid to the gift and estate tax consequences of such a trust. There is significant commentary on the use of joint trusts generally (however, not particularly in the business planning context). *See generally*, Nancy E. Shurtz, *An Academic's View of Tax Basis Revocable Trusts*, 134 Tr. & Est. 43 (Jan. 1995); Richard A. Williams, *Stepped-up Basis in Joint Revocable Trusts (Tax Planning for Married Couples)*, 133 Tr. & Est. 66 (June 1994); Richard A. Williams, *The Benefits and Pitfalls of Joint Revocable Trusts*, 131 Tr. & Est. 41 (Nov. 1992); Roy M. Adams and Thomas W. Abendroth, *The Joint Trust: Are You Saving Anything Other Than Paper?*, 131 Tr. & Est. 39 (Aug. 1992); Timothy L. Flanagan, *Designing Trusts for Couples Owning a Substantial Amount of Jointly Held Assets*, 15 Est. Plan. 84 (March/April 1988); Melinda S. Merk, *Joint Revocable Trusts For Married Couples Domiciled in Common-Law Property States*, 32 Real. Prop. Prob. & Tr. J. 345 (1997). Unfortunately, the topic has received very little attention from the Service. So far, the Service issued Technical Advice Memorandum 9308002 on the issue of joint revocable trusts, along with Pvt. Letter Ruls. 200101021 and 200210051, which fall in its wake. This TAM, which will be considered in detail below, is considered by many commentators to be largely incorrect and the Service's analysis essentially flawed. Paul M. Fletcher, *A Practitioner's View of Tax Basis Revocable Trusts*, 134 Tr. & Est. 31, 34 (Jan. 1995); Frederic Nicholson, *Ruling on the Joint Spousal Trust Ignores Statutory Intent*, 59 Tax Notes 121 (Apr. 5, 1993). This would be less of a problem if there was contravening authority.

Although it seems a bit of an overreaction to let a flawed TAM eliminate an extremely useful tool, it is imperative that the clients understand that, at this point, the use of joint trusts, coupled with a taxable estate, is an aggressive estate planning tool which carries some risk. Providing clients with an analysis of the "best case and worst case" tax scenarios may be the best way to ensure that they understand the implications of a joint trust and are able to work through a meaningful cost/benefit analysis.

Since joint trusts are used sporadically, and inconsistently for a variety of different purposes, there is no “standard” language. Although this gives the practitioner significant flexibility in drafting trust terms to suit the needs of the client, all of the terms must be carefully analyzed to achieve a desired result. “Standard” or boilerplate trust language should not be used without careful review of the potential tax implications.

This Article was drafted with the intent of making the joint revocable trust as “bulletproof” as possible. To that end, the most conservative course has been followed wherever possible. This was done intentionally in an effort to reduce the risks associated with the use of such a trust and is not meant to imply that other options might not accomplish the same goals.

**GIFT TAX CONSEQUENCES** • Many joint trusts in common law property states are drafted to avoid completed gifts between the settlors at the point of funding. Many of these trusts are essentially drafted as two parallel trusts contained within a single document. However, to maximize the usefulness of a joint trust and achieve the desired full step-up in basis at the first death, it is important that the gifts be completed. (If the gifts to the trust are not completed gifts, then the decedent’s estate will only include his or her contribution to the trust under sections 2036 and 2038. Consequently, the surviving spouse only receives a stepped-up basis in the decedent’s half of the trust assets.) The only other way to include the surviving spouse’s contribution to the trust in the decedent’s gross estate is for the settlors to give each other a power of appointment over their respective contributions. §2041. (Two recent private letter rulings addressing some of the tax implications of such trusts are described in greater detail later in this article.)

A variation on this approach has been advocated by attorney Paul Fletcher as a *debt-paying power of appointment* (a trust provision giving the trustee authority to pay the taxes, debts, and expenses of the first grantor to die from any assets of the trust. However, for this debt paying power of appointment to be effective, the trustee must have been instructed to do so by that grantor in a writing, other than by will, that was signed, acknowledged, and delivered to the trustee before the death of that grantor). The Service unfortunately issued TAM 9308002 based upon Mr. Fletcher’s trust. In a very poorly analyzed and written opinion, the Service chose to disagree and did not allow the full step-up in basis.

The result of TAM 9308002 is that each spouse’s gift to the other via the funding of the trust must be completed at the time the trust is funded. A gift in trust generally is not complete to the extent the donor reserves a power over the property’s disposition. Treas. Reg. §25.2511-2(b). However, a donor is not considered to have retained such a power if it is exercisable *only in conjunction with a person having a substantially adverse interest in the property*. Treas. Reg. §25.2511-2(e).

When the couple has retained powers of revocation or disposition that *must* be exercised jointly and by mutual agreement, each has an interest in the trust assets that is adverse to the other. An “adverse interest” in the gift tax context has been defined as a “financial interest” or a “direct legal or equitable interest in the trust property.” *Commissioner v. Prouty*, 115 F. 2d 331, 335 (1st Cir. 1940). These adverse interests mean the gifts are completed. This provision is necessary to ensure

that the full value of the trust assets will be included in the estate of the first settlor to die. *See* generally §§2033, 2036, and 2038. The estate tax consequences are discussed below.

### **Equal Contributions**

The settlors should make equal contributions to the trust. If one settlor contributes more to the trust than the other settlor, it is very likely that such unequal interests will result in one settlor making an additional gift to the other settlor. To be certain that the gifts are not classified as terminable interests, all income from the trust must be allocated between the settlors proportionally to their respective contributions. For example, if W contributes 70 percent of the interests in the business and H contributes the remaining 30 percent, income from the trust should be allocated 70 percent to H (as the recipient of the 70 percent interest) and 30 percent to W (for the same reasons). To allocate income equally between the spouses in this situations leaves open the possibility that the IRS could argue that the gifts do not qualify for the unlimited marital gift tax deduction under section 2523. The IRS could argue that W has retained an interest in the gifted property such that the gift is not a qualified terminable interest. Although such an argument may seem unlikely, equal contributions should be an easy way to avoid the entire issue.

Equal contributions to the trust ensure that all income from the trust will be allocated to the settlors equally, assuming the couple file joint income tax returns. Each one-half of the property in trust produces one-half of the income. No adjustments need be made in reporting and allocating the income. In addition, equal contributions ensure that the maximum value of the trust assets (50 percent) is available to fund the credit shelter trust at the death of the first settlor to die.

### **Avoiding Completed Gifts To Remainder Beneficiaries At Funding**

There is some authority for the proposition that upon the death of the first settlor, a completed gift will have been made to the remainder beneficiaries of the credit shelter trust. Private Letter Ruling 8617006 involved a situation in which A and B established a revocable trust, and funded it with community property. The trust was revocable while both A and B were alive, but upon the death of A or B the trust would become irrevocable. At the death of B, one-half the value of the trust was included in B's gross estate for federal estate tax purposes. In accordance with the terms of the trust agreement, the trust became irrevocable and the agreement provided that trust income was to be paid monthly to A and that the trustee had discretionary power to invade trust principal for the benefit of A "if the net income is insufficient to provide for her maintenance, support, and comfort, any of the surviving trustor's legal obligations, and the preservation of [the grantor's] property."

The trust further required that the trustee consider all other resources available to A to meet A's needs. The Service concluded that because A had substantial other resources which could reasonably be expected to support A during the remainder of A's life, a completed gift had been made to the remainder beneficiaries of the trust in an amount equal to the value of the trust assets, less the value of A's retained income interest.

It is possible to avoid completed gifts to remainder beneficiaries at the death of the first settlor. The language that seemed to trouble the Service was that giving the Trustee the discretion to consider the other assets available to A. A, who was 73 years old at the death of B, apparently had significant assets of her own. The Service concluded, without any analysis, that “[i]t is apparent that A’s income trust alone should be more than adequate to satisfy any need that could reasonably be expected to arise during the balance of her lifetime.” The Service followed that statement with this: “The standard for the support, comfort, and maintenance is a traditional ascertainable standard which means that it is readily subject to supervision by a state court.”

The Treasury Regulations provide that if the donor transfers property into the trust but reserves any power over its disposition, the gift may be wholly or partially incomplete. If the donor transfers a property into the trust to pay income to the donor or accumulate it at the discretion of the trustee, *and the donor has retained testamentary power to appoint the remainder among his decedents*, no portion of the transfer is a completed gift. In addition, if the exercise of the trustee’s power in favor of the grantor is limited by a fixed or ascertainable standard, enforceable by or on behalf of the grantor, then the gift is incomplete as to the remainder beneficiaries to the extent of the ascertainable value of any rights thus retained by the grantor. Treas. Reg. §25-2511-2(b).

To avoid any dispute with the IRS over this issue, it is prudent to draft the trust with an eye to this issue. The trustee should not be required to consider the surviving settlor’s other assets before making principal distributions to the surviving settlor. As an extra precaution, the trust should be drafted to include a provision giving the surviving settlor a special power of appointment limited to the issue of the settlors, with regard to the assets in the credit shelter trust. This renders any gift to the remainder beneficiaries incomplete. Treas. Reg. §25-2511-2(c).

**ESTATE TAX CONSEQUENCES** • Since both settlors have made equal completed gifts to the trust and their joint action is required to amend or revoke the trust, the full value of the trust assets is included in the estate of the first settlor to die. §§2033, 2036, and 2038.

This analysis is a two-step process. The first step involves inclusion of the decedent’s contribution to the trust and the second step involves inclusion of the surviving settlor’s contribution to the trust in the decedent’s gross estate.

### **The Decedent’s Contribution**

Section 2036(a) provides that:

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... 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 (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom.

Further, section 2038(a) provides that:

The value of the gross estate shall include the value of all property—(1)...to the extent of any interest therein of which the decedent has at any time made a transfer...by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through exercise of a power...by the decedent alone or by the decedent in conjunction with any other person,...to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

The courts have stated on several occasions that when assets are transferred to a trust by the settlor and the trustee has the discretion to distribute the trust asset to the settlor, *even if that discretion is limited by an ascertainable standard*, the full value of the trust assets which may be distributed to the settlor are included in the settlor's gross estate. It is only when the trustee has complete and total unrestricted authority to distribute the assets in any way the trustee sees fit that the trust assets are excluded from the settlor's gross estate. *See Commissioner v. Irving Trust Co.*, 147 F.2d 946 (2d Cir. 1945), considering the Code precursors to sections 2037 (transfers taking at death) and 2038. In *Irving Trust*, the court stated:

In a case where the return of any part of the corpus to the settlor will depend solely upon the discretion of the trustee the true test as to its inclusion in the taxable estate of the settlor is whether the trustee is free to exercise his untrammelled discretion, or whether the exercise of his discretion is governed by some external standard which a court may apply in compelling compliance with the conditions of the trust instrument. *Id.* at 949.

The Treasury Regulations are also consistent on the issue of full inclusion in decedent's gross estate of the value of assets over which the decedent retained or reserved an interest or right with respect to all of the property transferred by him. Treas. Reg. §20.2036-1(a).

The joint trust should be drafted such that the decedent retains the right to the income of the property, the right to designate who will enjoy the income from the property, and the power, in conjunction with the surviving settlor, to alter, amend, revoke, or terminate the trust.

Under both sections, the full value of each settlor's contribution to the trust is included in the decedent's estate.

### **The Surviving Settlor's Contribution**

In addition, the settlors have made gifts to each other (by way of the trust) equal to the full value of their respective contributions to the trust. Each settlor's contribution is included in the *other* settlor's estate pursuant to section 2033, which provides: "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."

Despite the broad language of section 2033, the courts have required that for an asset to be included in the decedent's gross estate, his interest in the asset must be more than an expectancy. *Estate of Bender v. Commissioner*, 827 F.2d 884, 887 (3d Cir. 1987).

The value of a decedent's gross estate is determined by 26 U.S.C. §2033. That section provides that the value of a gross estate includes the value of all property to the extent of the interest therein held by the decedent at the time of his or her death. Generally, if interests are *contingent*, they are not includable in the decedent's gross estate, whereas, if the interests are vested, then they are includable in the gross estate under section 2033. (Emphasis added.) *Comerica Bank v. United States*, 93 F.3d 225, 228 (6th Cir. 1996).

State law determines whether an interest is *vested* or *contingent*. A gift in trust vests immediately if the trust beneficiary's right to receive the gift is not subject to a condition precedent, even if the time of payment is postponed. *First and American National Bank of Duluth v. Higgins*, 208 Minn. 295, 293 N.W. 585 (1940), citing Minnesota law. Courts of other jurisdictions have reached similar results applying the laws of other states. *See generally, Higgins v. U.S.*, 684 F.2d 417 (6th Cir. 1982), applying Tennessee law, and *Comerica*, *supra*, applying Michigan law.

In *Higgins*, the decedent, William J. Conan, created a revocable trust of which Joseph D. Conan was a beneficiary. William Conan created the trust in 1926 and died a few months later. The trust provided that the beneficiaries were to receive semi-annual income payments, discretionary principal payments, and the corpus of the trust at termination in 1941. Joseph Conan died in 1937. His will provided for the disposition of his interest in the trust. The issue before the court was whether Joseph Conan had an interest in the trust that he could dispose of in his will. The court stated that a beneficiary's right to a beneficial interest under a trust may be vested although such interest is given through the intervention of a trustee. Similarly, a gift in trust may vest with the beneficiaries even though title and dominion over the corpus are said to be vested with the trustee. In *Higgins*, the court stated that "[a] future gift is vested when the right to receive it is not subject to a condition precedent. Where the right to receive the gift is immediate and only the time of payment is postponed, the gift vests immediately." 293 N.W. at 313. The beneficiary has a "vested interest in the trust fund."

The joint trust should be drafted such that the settlors have a vested interest in the trust. The trust names the decedent as a settlor, trustee, and beneficiary of the trust. During the time both settlors are alive they maintain the right and the power to control distribution from the trust. No contingency must occur or lapse before the settlors, as beneficiaries of the trust, have a right to receive distributions from the trust.

### **Funding The Credit Shelter Trust**

Since the couple has transferred only their business interests to the joint trust, in equal shares, the assets contributed by the decedent are clearly distinguishable at the decedent's death. Only the decedent's contribution to the joint trust should be used to fund the credit shelter trust. If the value of the decedent's contribution to the joint trust is less than the decedent's then available unified credit equivalent, other assets of the decedent can be used to fully fund the credit shelter trust. To the extent the value of the decedent's contribution to the trust exceeds the then available unified credit equivalent amount, the trust assets should be allocated to the marital trust. Naturally, the full value of the marital trust is included in the estate of the second settlor to die, whether it is a QTIP trust, or a marital trust in which the

surviving settlor has withdrawal powers, or a general power of appointment. As we will discuss later, a QTIP trust is probably the better choice.

**MARITAL DEDUCTION ISSUES** • The unlimited marital deduction will offset any estate tax that may be due by virtue of inclusion of the trust assets in the estate of the first settlor to die. §2056. The trust should be drafted such that only those trust assets that qualify for the marital deduction are allocated to the marital trust. Those assets not distributed to the credit shelter trust can be distributed to a marital trust if the requirements for the marital deduction are followed. For example, if a QTIP trust is used, the surviving settlor should be given the right to convert all the assets into income-producing assets and the trustee should be required to distribute all of the income of the trust to the surviving settlor at least annually. §2056(b)(7).

If the surviving settlor wishes to make gifts and a QTIP trust is used, the trustee should distribute trust principal to the surviving settlor for subsequent distribution to the third party rather than distributing outright to the third party. §2056 and Treas. Reg. §20.2056(b)-7. Gifts from the trust necessarily reduce its value at the surviving settlor's death for estate tax purposes.

**INCOME TAX BASIS** • The test for determining what property is to be given a step-up in income tax basis is generally whether the property was included in the gross estate of the decedent. The basis of an asset acquired from a decedent is the fair market value of that asset at the date of death, or at the alternate valuation date. Section 1014(b) describes multiple situations in which property will be considered to have been *acquired from or have passed from the decedent*. This includes the situations that are easily recognized as acquisitions from a decedent, such as by bequest, devise, or inheritance. It also includes situations less likely to fit into a non-tax definition of acquisition from a decedent, such as property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will and all property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise and non-exercise of the power of appointment, if the property is included in the decedent's gross estate.) §1014(b)(1) through (9).

Section 1014(b)(9) makes the use of the joint trust attractive. As discussed above, the full value of the trust assets is included in the estate of the first settlor to die. The trust assets receive a full step-up in basis. Therefore, the only gain the surviving settlor need recognize upon the sale of the business is the gain on the appreciation in value from the date of death.

The only additional requirement is that both settlors must survive for one year following the transfer of the business assets to the trust. Section 1014(e) provides an exception to the general rule stated in section 1014(a). Section 1014(e) states that if the *decedent* received appreciated property by gift during the one-year time period ending on his or her death, and the property is reacquired by the donor from the decedent, the donor receives the decedent's carryover basis in the property. There is no stepped-up basis in this situation.

Essentially, section 1014(e) disallows a stepped-up basis for property transferred to the decedent within one year of death and subsequently reacquired by the donor (or the donor's

spouse) by reason of decedent's death. Section 1014(e) was drafted to prevent perceived abuses by which deathbed transfers of appreciated property could be made by a donor to the decedent, with the understanding that the decedent would devise the property back to the donor at death. The appreciated property is returned to its original owner, but with a new stepped-up basis. Such a transfer would have the effect of allowing previously fully depreciated property to again be depreciated and allowing the donor to sell the appreciated property and escape taxation on the gain.

### **Use Of A QTIP Trust**

Arguably, the acquisition of the property by a QTIP trust established within the terms of the joint trust would avoid the provisions of section 1014(e). If any appreciated property to which section 1014(e) applies is sold by the estate of the decedent or by a trust in which the decedent was a grantor, the carryover basis rules apply to the extent the donor of the property (or the donor's spouse) is entitled to the proceeds of such sale. However, assuming a sale of the assets occurs after a distribution of the trust assets to the QTIP trust or the credit shelter trust, the trustees of the QTIP and credit shelter trusts are the recipients of the proceeds of the sale as legal owners of the trust assets for the benefit of the trust beneficiaries. Neither the donor nor the donor's spouse is entitled to the proceeds. As such, section 1014(e) could be avoided. A QTIP trust is probably a better choice than a marital trust that gives the surviving settlor a right of withdrawal or a general power of appointment. A QTIP trust eliminates any argument the Service could make that the surviving settlor is the actual recipient of the proceeds.

**TAM 9308002** • Technical Advice Memorandum 9308002 involved a joint revocable trust created by the decedent and her spouse. The trust was funded largely with joint assets; however, the decedent also conveyed some individual property to the trust. The trust itself required the income to be distributed to the decedent and the spouse, and provided that principal could be distributed to decedent and her spouse for their health, education, support, and maintenance. Either the decedent or her spouse could revoke the trust during their joint lifetime, in which case an undivided one-half interest in the trust property would be distributed to each of them. At the decedent's death a one-half interest in the trust passed to her spouse. The trust contained a debt-paying power of appointment, but it could only be exercised during lifetime and a notice was required to be given to the other spouse if either decided to exercise that power of appointment. The personal representative of the decedent's estate included the full value of the trust assets in the decedent's estate under section 2041. (Section 2041 states that the gross estate of a decedent shall include the value of all property of the decedent at the time of death, including property over which the decedent had a general power of appointment.)

### **The Problem**

The issue in TAM 9308002 was whether the basis in the property was stepped-up to the full fair market value of the property on the date of decedent's death. As previously stated, section 1014(a) states that the basis in property "acquired from decedent" is the date of death

value. Property “acquired from the decedent” includes property acquired by exercise or nonexercise of a power of appointment if the property is included in decedent’s estate. As noted above, section 1014(e) requires the donor to relinquish dominion and control over the property for a full year before death in order to achieve the stepped-up basis. The Service reasoned that because the power to revoke the trust terminated at the death of the decedent, the decedent never actually relinquished dominion and control over the property, so section 1014(e) prevented a full step-up in basis. However, section 2041 still requires that the full value of the property be included in the decedent’s estate.

The problems with this analysis are multiple. First of all, section 1014(e) states “property acquired by decedent *by gift* from the donor...” If there is no relinquishment of domain and control by the donor, there has been no gift. For a gift to be complete, and therefore subject to a gift tax, the donor must have so parted with dominion and control as to leave him no power to change its disposition. Treas. Reg. §25.2511-2(b). In TAM 9308002, the Service based its decision in part upon its conclusion that the decedent never actually relinquished dominion and control over the property. In this TAM, the surviving spouse acquired the property by the nonexercise of the power of appointment on the part of the decedent, not by gift. Included in the definition of “acquired from decedent” under section 1014(a) is property acquired from the decedent by reason of “death...or other conditions” (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in decedent’s gross estate. Arguably, this TAM stands for the proposition that any time a decedent dies with a general power of appointment, either exercised or nonexercised, section 1014(e) prevents a full step-up in basis. Such a result is clearly not the intended purpose of section 1014(e). Arguably, this TAM also stands for the proposition that a power of appointment is equal to a gift. However, this cannot be the case since a power of appointment specifically and by definition deals with the property of another while a gift deals with property of a donor.

#### **Pvt. Letter Ruls. 200101021 and 200210051**

The position of the Service in Pvt. Letter Ruls. 200101021 and 200210051 follows the rationale of TAM 9308002. In both rulings the donors were husband and wife who established a joint revocable trust funded with joint property and, in 200210051, some individual property. Either donor could revoke or amend the trusts. At the first death, the trusts become irrevocable and the assets were allocated to unified credit trusts with the balance to the surviving spouse (in trust, 20021005, or outright, 200101021). In 200101021, the first donor to die possessed a testamentary general power of appointment over all assets of the trust to the donor’s estate or to any other persons or entities as specified in the donor’s will. In 20021005, both donors possessed the authority to direct the trustees to pay to the donors, or in accordance with their instructions, so much of the principal of the entire trust as either donor directed. The Service concluded in both situations that the deceased donor’s contribution to the trust was includable in that donor’s estate pursuant to section 2038 and the surviving donor’s contribution was includable in the donor’s estate pursuant to section 2041 (the gross estate includes any property over which the decedent possessed, at the time of death, a general power of appointment). In both rulings, the Service stated that section 1014(e) would apply to

any trust property includable in the deceased donor's estate that was attributable to the surviving donor's contribution and was acquired by the surviving donor by virtue of the deceased donor's exercise, or failure to exercise, the general power of appointment thus preventing a step up in basis for those assets. As with the TAM, the end result is full inclusion of trust assets in the estate of the first grantor to die, but a stepped-up basis for only the decedent's contribution.

### **A Solution**

TAM 9308002 and the two letter rulings could be more easily ignored if there were other contravening authority from the Service. Unfortunately, there is not. A reading of the TAM could lead one to the conclusion that the Service decided its position and then worked backwards to make its analysis fit that decision. In the end, there has been substantial criticism of this TAM, most of which is justified. The analysis is simply flawed. However, flawed as it is, it remains the Service's apparent position on joint revocable trusts. Debt-paying power of appointment trusts may not be the solution in light of the Service's position. A more logical solution is to have completed gifts with a retained power exercisable in conjunction with another person having an adverse interest in the trusts, and ideally, allowing the one-year time period to lapse after transferring the assets to the trust. In this situation there is no power of appointment that will remain unexercised at death.

A debt-paying power of appointment trust as was referenced in this TAM is probably a less-complicated arrangement for achieving the goals set out in this article. However, until the IRS changes its position, or the Tax Court reviews and reverses the Service's position on joint revocable trusts, advising a client to enter into such a trust arrangement seems unwise.

**TRANSFERS FOR INSUFFICIENT CONSIDERATION** • Finally, a possible interpretation of section 2043 may lead to the inclusion of only one-half the trust assets in decedent's gross estate, and therefore, provides that the gross estate of decedent shall include only the excess of the fair market value of the property transferred in trust over the consideration paid for such property. A potential interpretation of this section could lead one to conclude that equal contributions to the trust by each settlor would be *consideration* of an equal amount and therefore, only one-half of the value of the trust assets would be included in the estate of the first settlor to die. In that case, only one-half of the value of the trust assets would receive a step-up in basis at the death of the first settlor to die.

This interpretation hinges on an analysis that equates *gifts of equal amount* with *consideration*. For the purpose of the Federal gift tax, the value of a gift is the value of the property transferred less the value of the donor's retained rights in the property. Treas. Reg. §25.2511-1(e); Rev. Rul. 69-505, 1962-2 C.B. 179. Because the settlors' gifts are completed at the date the transfers are made, the settlors have retained no rights in the property, except in conjunction with each other. §2043.

**CONCLUSION** • Joint revocable trusts are not for everyone. Given the risks and potential benefits, they do not make sense as a "general purpose" revocable trust. Joint revocable trusts

are only for the client that holds a low-basis, high-value asset. In addition, the client must be comfortable with the risk factors. To reduce the risks associated with this type of joint revocable trust, conservative choices have been recommended and the riskier options eliminated throughout this article. As discussed above, this is the reason equal contributions to the trust and a QTIP marital trust are recommended. The goal is to limit the risks to those that are actually necessary to achieve a full step-up in basis at the death of the first settlor to die.

Obviously, the worst-case scenario is that all of the assets of the trust are included in the gross estate of the first settlor to die but the stepped-up basis only applies to one-half the assets. This is an unlikely scenario given that planning for a full marital deduction at the first death is a common estate planning device. No estate planning attorney should have any problem with this aspect of the joint revocable trust.

A more likely scenario is that only one-half of the assets are included in the gross estate of the first settlor to die and therefore, the surviving spouse receives a stepped-up basis for only those assets. The assets to receive the stepped-up basis are those contributed by the deceased settlor.

The weakest link in the analysis deals with the inclusion of the surviving settlor's contributions to the trust in the gross estate of the deceased settlor. The analysis is sound and accurate; however, it is untested in this context and therefore, carries some risk.

The realistic worst-case scenario leaves the clients in a position which is no worse than they would have been in had they prepared individual trusts funded with one-half of their combined assets. The only harm to the clients is the transaction costs and perhaps the cost of litigating the issue with the IRS. Although the costs of litigating with the IRS should not be minimized, the decision regarding the extent to which the client wishes to engage in this litigation does not need to be determined until the death of the first settlor. The issue may even be postponed until the business is sold by the surviving settlor and the income tax issues are addressed.

The *debt-paying power of appointment* joint revocable trust is a less complex choice than the trust provisions set out in this article. However, TAM 9308002 makes it an unacceptable choice for some practitioners. The trust set out in this article offers a viable, albeit aggressive, alternative.

## **PRACTICE CHECKLIST FOR**

### **Drafting Joint Revocable Trusts**

The ideal clients for a joint trust are a married couple who own a high-value, low-basis business, who intend to sell the business at some point but in all likelihood after the first death, and who have a good marriage such that divorce is unlikely.

- For these clients, transferring the business ownership to a joint trust can provide a full step-up in basis at the first death. Those assets allocated to the surviving spouse or a qualified trust for the benefit of the surviving spouse will receive a second step up in basis equal to the date-of-death value. §1014(a).

\_\_\_ Essentially, the idea is that the clients each contribute equal interests in the business to the trust (such as 50/50 ownership in stock of their corporation).

\_\_\_ The full value of the trust assets, that is, the full value of the business as a going concern, is included in the estate of the first spouse to die.

\_\_\_ The business interests can be allocated between a marital trust and a credit shelter trust. Both trusts are available for the benefit of the surviving spouse. The surviving spouse can act as a trustee of both trusts and thereby maintain some control over the business. The surviving spouse (via the trusts) receives a full step-up in basis, not only for the interest of the deceased spouse, but also for the interest of the surviving spouse.

- Although such a joint trust has the potential to be extremely useful, it is full of potential traps. Very careful attention must be paid to the gift and estate tax consequences of such a trust.

\_\_\_ To maximize the usefulness of a joint trust and achieve the desired full step-up in basis at the first death, it is important that the gifts be completed.

\_\_\_ The settlors should make equal contributions to the trust.

\_\_\_ The trustee should not be required to consider the surviving settlor's other assets before making principal distributions to the surviving settlor. As an extra precaution, the trust should be drafted to include a provision giving the surviving settlor a special power of appointment limited to the issue of the settlors, with regard to the assets in the credit shelter trust.

\_\_\_ The joint trust should be drafted such that the decedent retains the right to the income of the property, the right to designate who will enjoy the income from the property, and the power, in conjunction with the surviving settlor, to alter, amend, revoke, or terminate the trust.

\_\_\_ The joint trust should be drafted such that the settlors have a vested interest in the trust.

\_\_\_ Only the decedent's contribution to the joint trust should be used to fund the credit shelter trust.

\_\_\_ The trust should be drafted such that only those trust assets that qualify for the marital deduction are allocated to the marital trust. Those assets not distributed to the credit shelter

trust can be distributed to a marital trust if the requirements for the marital deduction are followed.

\_\_\_ The acquisition of the property by a QTIP trust established within the terms of the joint trust would avoid the provisions of section 1014(e).

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