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## The Use and Abuse of Revocable Trusts

Howard M. Zaritsky

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# THE USE AND ABUSE OF REVOCABLE TRUSTS

by  
Howard M. Zaritsky  
Zaritsky & Zaritsky  
Fairfax, Virginia

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## THE USE AND ABUSE OF REVOCABLE TRUSTS

By

Howard M. Zaritsky\*

- I. INTRODUCTION. Over the past 20 years the use of revocable trusts in estate planning has grown to such an extent that, while such trusts cannot be said to have replaced wills, they do appear as the cornerstone of much of modern estate planning. This increasing role played by revocable trusts gives rise to two serious concerns.

First, there is a tendency to use revocable trusts as a panacea, rather than as a specific device to cope with a specific problem or set of problems.

Second, and of even greater concern, is the common failure of many practitioners to comprehend the tax and nontax ramifications of the use of revocable trusts, particularly in the post mortem aspect.

This outline examines when a revocable trust should be used in a modern estate plan, the problems that may arise in drafting and administering a revocable trust, and the life-time and post mortem tax consequences of the use of revocable trusts.

## II. THE REVOCABLE TRUST: A DEFINITION.

- A. General. A revocable trust is an inter vivos trust over which the grantor retains the power to revoke the trust and reacquire its assets.
1. Express power. Generally, and in Virginia, a power to revoke must be retained expressly. A trust which is silent as to this power is deemed irrevocable. Restatement (Second) of Trusts, Sec.

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\* Howard M. Zaritsky is a partner in the Fairfax, Virginia law firm of Zaritsky & Zaritsky. He is a member of the Virginia and Florida bars, and a fellow of the American College of Probate Counsel. Among his more recent books is Tax Planning for Family Wealth Transfers (Warren, Gorham & Lamont, Inc. 1985).

330 (1959) ("RESTATEMENT"); 4 A. W. Scott, SCOTT ON TRUSTS, Secs. 330, 330.1, 330.3, 332 (3d Ed. 1967 & Supp. 1987) ("SCOTT"). However, some other states follow the opposite policy and presume that a trust is revocable unless it denies the power to revoke. See Cal. Civ. Code Sec. 2280 (West. 1985); N.Y. Est., Powers & Trusts Law Sec. 7-1.9 (McKinney, 1967, Supp. 1987).

2. Narrowly construed. A power to revoke a trust will be narrowly construed, so that a power to revoke is not normally deemed exercisable testamentarily, unless the instrument says so. *Cohn v. Central National Bank*, 191 Va. 12, 60 S.E. 2d 30 (1950); see also *Euart v. Yoakley*, 456 So. 2d 1327 (Fl. Dist. Ct. App. 1984) (power to revoke trust upon notice to trustee is not exercised by specific devise of real estate owned by trust). Even if revocation by will is expressly authorized in the trust instrument, a mere residuary bequest should not revoke the trust and bring its assets into the probate estate. See *Old Colony Trust Co. v. Gardner*, 264 Mass. 68, 161 N.E. 801 (1928); *Re Pozzuto's Estate*, 188 A. 209 (1936).
3. Incapacitated grantor. If the grantor becomes incapacitated, a committee or guardian may revoke the trust only if so stated and authorized in the trust instrument. See *Chase National Bank of City of New York v. Ginnel*, 50 N.Y.S. 2d 345 (1944); *Friedrich v. BancOhio National Bank*, 470 N.E. 2d 467 (Ohio App. 1984). If the grantor becomes incapacitated and then tries to revoke the trust, the trustee should resist the grantor's attempted revocation. See *Florida National Bank of Palm Beach v. Genova*, 460 So. 2d 895 (1984) (trustee has a duty to inquire into the circumstances surrounding a grantor's attempted revocation of a trust, but the trustee should submit the matter to judicial determination).
4. Attorney-in-fact's power. An attorney in fact usually cannot revoke a revocable trust unless the power of attorney specifically grants the power. See, however, Ill. Ann. Stat. Ch. 100 1/2, Sec. 11a-23 (1985).

- B. Joint Powers. The grantor's power to revoke the trust may be exercisable alone or in conjunction with another person. See *Heintz v. Comm'r*, T.C. Memo. 80,524 (1980). Someone who holds a joint power to revoke a trust exercisable with the trust's grantor must not act dishonestly or unreasonably withheld. *Dewey v. State Tax Comm'n*, 346 Mass. 43, 190 N.E. 2d 203 (1963); SCOTT, Sec. 330.10.
- C. Funding. A revocable trust may be either unfunded (awaiting a pourover from a will), fully funded (with the grantor's entire estate), or partially funded (with specific assets).
- D. Inadvertently Irrevocable Trusts. An irrevocable trust created under a mistake of fact or law can, in some states, be reformed into a revocable trust. See SCOTT Sec. 332; *Ryan v. Brennan*, 1 Mass. App. 469, 301 N.E. 2d 257 (1973) *Hines v. Louisville Trust Co.*, 254 S.W. 2d 73 (Ky. 1952); *Liberty Trust Co. v. Weber*, 90 A. 2d 194, 200 Md. 491 (1952); and *Colbo v. Bruyer*, 235 Ind. 518, 134 N.E. 2d 45 (1956). Any gift taxes paid on the creation of a mistakenly irrevocable trust should be refundable. *Dodge v. United States*, 413 F.2d 1239 (5th Cir. 1969) 1939), cert. denied 309 U.S. 680 (1940) (mistake of fact); *Touche v. Comm'r*, 58 T.C. 565 (1972) (scrivner's error); and *Berger v. United States*, 487 F. Supp. 49 (W.D. Pa. 1980) (mistake of fact).

### III. THE REASONS FOR USING A REVOCABLE TRUST.

#### A. Management of the Grantor's Property.

- 1. Current management--the funded revocable trust. A funded revocable trust may be useful for various persons who need current management of their wealth, or who merely wish to provide for such management.
  - a. For persons incapable or not desirous of managing wealth, including:
    - (1) Elderly or infirm persons.
    - (2) Inexperienced persons, including those with recently inherited wealth.

- (3) Persons who have recently attained the age of majority and have received a substantial distribution from a Uniform Gift to Minors Act custodianship or an Internal Revenue Code ("IRC") Sec. 2503(c) trust.
  - (4) Persons lacking time to manage their wealth, such as entertainers, business executives, busy entrepreneurs, and successful professionals.
  - (5) Persons whose employment takes them frequently away from the United States for significant periods of time (1 year or more), making asset management difficult, though such persons should also consider less restrictive and often less expensive management alternatives, including agency relationships, investment advisory services, mutual funds, common trust funds, or a power of attorney.
- b. For persons who manage their own assets, but who need the trust for certain types of wealth, including:
- (1) Fractional interest in real estate or oil and gas. When an interest is bequeathed to a number of persons, a revocable trust can be used to hold the interests and permit convenient and sensible management. On some of the tax consequences of such a trust, see Ltr. Rul. 8104202, discussed infra.
  - (2) Divided ownership of closely-held corporate stock. When family members own a corporation's stock, a revocable trust can be used to hold all of their interests, simplifying voting and business management. However, beware tax complications under IRC Secs. 303, 6166A, and subchapter S, discussed infra.
- c. To manage individual assets which should be segregated from the rest of the estate, including:

- (1) Contract rights. Certain types of contract rights ought to be kept out of the probate estate but should be made available to solve estate and beneficiary liquidity problems. Such rights include rights to royalties, deferred compensation payments, and unpaid installments of a debt obligation (on installment obligations, see also Rev. Rul. 73-584, 1973-2 C.B. 162, and Rev. Rul. 74-613, 1974-2 C.B. 153 [transfer of an installment obligation to a revocable trust is not a disposition under the pre-1980 rules] and Rev. Rul. 76-100, 1976-1 C.B. 123 [neither revocation of the trust and return of the obligation to the grantor nor the disposition of the obligation at the grantor's death are dispositions under the pre-1980 rules]). See infra.
- (2) Community Property. Individuals who move from a community property state to a non-community property state may still own community property and may desire to maintain its special status. Similarly, individuals who move into community property states may wish to preserve the status of separate property. Either result can be achieved through a revocable trust, drafted artfully with several special provisions. On the retention of the status of community property brought into Virginia from a community property state, see *Commonwealth v. Terjen*, 197 Va. 596, 90 S.E. 2d 801 (1956); also see J. Rodney Johnson, "Estate, Gift and Income Tax Aspects of Virginia's Transplanted Community Property--A Primer--," 29 VA. BAR NEWS 24 (October 1980).
  - (a) A clear statement of the intent to maintain the status of the trust res as separate or community property. See generally "The Revocable Living Trust as an Estate Planning Tool," (Report of the Committee on Estate and Tax

Planning) 7 REAL PROP., PROB. & TR. J. 223, 229 (Summer 1972); and "Estate Planning for the Migratory Executive: A Panel," 5 REAL PROP., PROB. & TR. J. 407 (Winter 1970).

- (b) Avoid giving a spouse powers over the corpus inconsistent with the type of property the trust seeks to maintain. If property is to be separate, do not give each spouse joint managerial authorities. See generally Stanley M. Johanson, "Revocable Trusts and Community Property: The Substantive Problems," 47 TEX. L. REV. 537 (March 1969); and Stanley M. Johanson, "Revocable Trusts, Widow's Election Wills, and Community Property: The Tax Problems," 47 TEX. L. REV. 1247 (Nov. 1969).
  - (c) Before deciding to retain separate property status upon moving into a community property state, consider the basis adjustment to the entire property, not merely the decedent's one-half interest, allowed under IRC Sec. 1014(b)(6); see also Rev. Rul. 66-283, 1966-2 C.B. 297.
  - (d) This type of trust cannot be used to defeat the rights of the surviving spouse. See *Land v. Marshall*, 426 S.W. 2d 841 (Tex. 1968), in which a husband sought to defeat his wife's right in community property by transferring it to a revocable trust over which he maintained sole managerial control, but the court held that the action was in fraud of the wife and the trust could be ignored.
- d. To manage business interests during transitional periods. A revocable business interest transition trust may be used to manage an interest in a closely-held business

for a limited, transitional period, such as when an owner's health is impaired or when the owner wishes to try out a youthful successor, without permanently transferring ownership.

- (1) The revocable trust gives the youthful successor, as trustee and, perhaps, a beneficiary, a chance to manage the business under the watchful eye of the grantor, who can always revoke the trust and reacquire the business interest if desired.
- (2) The successor's interest will permanently vest upon the grantor's death.
- (3) Beware tax problems under IRC Secs. 303, 6166A and subchapter S, discussed infra.

e. To manage real estate. A revocable trust offers a pass-through of deductions for interest and depreciation (though not affording a pass through of deductions in excess of income), making it initially appealing as a management vehicle for real estate, though difficult problems can arise with respect to how title should be held.

- (1) Title held by the trustees. In Virginia, title to real property can be held directly by the trustees without having to record the trust agreement. Some title examiners will refuse to approve title to property held in a fiduciary capacity without seeing a copy of the trust agreement.
  - (a) The examiner may have a legitimate interest in seeing the trust agreement to establish the trustee's right to sell the property. See Va. Code Sec. 55-61.1 (Repl. vol. 1986). See, however, Colo. Rev. Stat. Sec. 38-30-108 (Rep. vol. 1982), expressly permitting the passage of good title to property

held by a trust without examination of the trust agreement.

- (b) Unlike Virginia's rules, in some states trusts are subject to the same usury restrictions as individuals. In Virginia, real estate investment trusts are not subject to the usury rate limitations. Va. Code Sec. 6.1-330.43 (Repl. vol. 1983).
- (2) Nominee corporation. The trust could establish a nominee corporation to hold title to real estate on its behalf, thus simplifying title recordation and avoiding usury limitations in many states. However, the IRS has repeatedly contended that nominee corporations had to be taxed like ordinary corporations, eliminating the pass-through of real estate expenses and deductions. They have often won, too. See e.g., *Ourisman v. Comm'r*, 760 F. 2d 541 (9th Cir. 1985), rev'g 82 T.C. 171 (1984); *Raphan v. U.S.*, 759 F. 2d 879 (Fed. Cir. 1986), cert. denied 106 S. Ct. 129 (1985); but also see *Roccaforte v. Comm'r*, 708 F. 2d 986 (5th Cir. 1983), rev'g 77 T.C. 263 (1981) (partnership treated as owner of real property despite legal title in nominee corporation). See also Stanley D. Rosenbaum, "Unique Applications and Pitfalls of Revocable Trusts," 29 U.S.C. TAX INST. 503, 504-05 (1977); and Joel E. Miller, "The Nominee Conundrum: The Live Dummy is Dead, but the Dead Dummy Should Live!" 34 TAX L. REV. 213 (1979).
- (3) Nominee partnership. The best choice in many states (including Virginia) is the nominee partnership, composed of the trustees and declaring the purpose of the venture to be the holding and management of real estate. The title can be recorded in the name of the partnership merely by filing a trade name affidavit, and most title examiners will pass upon the title without requesting

to see the partnership agreement. Furthermore, the usury limitations do not apply to partnerships. Va. Code Sec. 6.1-330.43 (Repl. vol. 1983).

The trustees should be careful, however, that special tax elections are made at the partnership level, rather than by the trustees as partners or fiduciaries. See e.g., *Rothenberg v. Comm'r*, 48 T.C. 369 (1967); and Rev. Rul. 79-84, 1979-1 C.B. 223 (in which a partnership election under IRC Sec. 754 had to be made by the partnership, rather than by the trustees).

2. Future management. A funded or unfunded revocable trust may be used also to provide for the future management of the assets of an individual who is presently capable of managing his or her own wealth. The trust may provide for management upon the disability of the individual during his or her own lifetime, or for post mortem management of the individual's assets for the benefit of the individual's family.
  - a. Incompetency and the revocable stand-by trust. The creation of a revocable trust for future management of the grantor's estate in anticipation of future incapacity, due to senility, recurring disease, or serious disability, is an extremely useful device. Generally, see Barbara K. Lundergan, "Sudden Decline in Health of Client may Provide the Impetus for Planning his Estate," 6 ESTATE PLANNING 8 (1979); Edward O. Osterberg, Jr. "Current Trends and Techniques in the Use of and Drafting of Revocable Trusts," 47 J. TAX'N 332 (1977); and see also "The Revocable Living Trust as an Estate Planning Tool," (Report of the Committee on Estate and Tax Planning) 7 REAL PROP., PROB. & TR. J. 223, 224-25 (Summer 1972).
    - (1) Superiority over other devices. The revocable stand-by trust is a generally superior alternative to a durable power of attorney or a committeeship.

- (a) It can authorize far greater powers for the trustee than can either a durable power or a committeeship. See Va. Code Sec. 8.01-67 et seq. (Repl. vol. 1984).
  - (b) It is certainly less expensive to establish and administer than a committeeship, since it does not require on-going supervision by the courts.
  - (c) There also are questions regarding the relationship between attorneys-in-fact and subsequently appointed committees and guardians. See, Va. Code Sec. 11-9.1 (Repl. Vol. 1985), requiring the holder of a durable power of attorney to report to and be subject to the control of a subsequently-appointed committee or guardian. If the power grants the attorney-in-fact powers in excess of those of the committee, it is not clear whether the appointment of the committee acts to limit the attorney-in-fact's authority.
  - (d) The grantor can pick the trustee--it is hard to pick one's committee.
- (2) Funding. The revocable stand-by trust may be presently funded with all or a significant portion of the grantor's assets, or it may be unfunded (or nominally funded), but another person may have a durable power of attorney to fund the trust after the grantor's incapacity.
  - (3) Beneficiaries. The grantor should always be the main present beneficiary of the stand-by trust, though it is useful to allow the trustees to make discretionary \$10,000 corpus distributions to a broad class of other beneficiaries, including most of the grantor's family members, enabling the

trustee to reduce the size of an incompetent grantor's estate without incurring a gift tax.

- (a) These distributions may be conditional upon the grantor being disabled for an extended period of time (two to five years seems appropriate).
  - (b) If the grantor is married and his or her spouse consents to gift-splitting (IRC Sec. 2513), the amount of the permissible distributions should be \$20,000 per year per donee.
  - (c) If the grantor has a very large estate, consider designating a charitable institution as the beneficiary of a large discretionary trust distribution if the grantor remains incapacitated for an extended period of time.
  - (d) The IRS has said in private rulings that a gift made from a revocable trust within three years of a grantor's death is includible in the grantor's gross estate. The IRS noted that the trustee's authorized gift constituted a partial release of the grantor's power to revoke the trust, and since the release occurred within three years of the grantor's death, the property was brought back into the estate. See Ltr. Rul. 8609005. When a revocable trust did not authorize such gifts expressly, the same result was reached. Ltr. Rul. 8635007.
- (4) Trustees. There should be either a co-trustee with the grantor or a successor trustee named. The co-trustee or successor trustee should be the person who will manage the grantor's estate in case of incapacity.

- (a) The grantor should have full managerial authority during his or her capacity.
  - (b) The other fiduciary should be entirely relieved of all liability for the grantor's actions during the grantor's capacity. If the other fiduciary is corporate, they will normally require such exculpation.
- (5) Shift of control. When the grantor becomes incapacitated, the control over trust managerial decisions should shift to the other trustee.
- (a) Incapacity should be as determined by a physical designated, either by credentials or by name, in the trust instrument. Cantwell, "Adjudication--Avoidance through Living Trust," 1 REAL PROP., PROB. & TR. J. 366 (Winter 1966).
  - (b) When there is particular reason to believe that the grantor may be ornery when incapacitated, use a panel of physicians to provide additional support in case of a court contest.
  - (c) The shift should be a suspension of the grantor's powers, not a termination, and the trust agreement should clearly reflect this. A permanent shift in control would probably be a taxable gift to the remainder beneficiaries (not qualifying for the annual exclusion). See Treas. Regs. Secs. 25.2511-2(b), (c) and 25.2511-3.
- (6) Power to revoke. Only the grantor should have the power to revoke the instrument, since you do not want someone else revoking it after the grantor's incapacity.

b. The revocable life insurance trust. Personal life insurance trusts, the use of which has grown in recent years, are sometimes vehicles for estate tax savings but often also means to assure competent management of the insurance proceeds for the benefit of the insured/grantor's family. When the insured does not wish to surrender the present control over his or her policy, or does not wish to incur a gift tax liability, a revocable trust can still provide post mortem management of the proceeds.

(1) Alternatives. The use of a revocable life insurance trust is just one device to manage life insurance proceeds. You should always consider the others, as well.

(a) Settlement options. Life insurance companies will provide alternate payment schedules which are self-managing, including payment of the proceeds in installments or as an annuity. However, revocable life insurance trusts commonly provide greater flexibility in management and investment, a significantly higher investment return, and they can be drafted to assure qualification for the estate tax marital deduction. See Rev. Rul. 64-310, 1964-2 C.B. 342; and Rev. Rul. 55-733, 1955-2 C.B. 388; but also see Rev. Rul. 77-130, 1977-1 C.B. 289; and Rev. Rul. 57-423, 1957-2 C.B. 623.

(b) Testamentary insurance trust. Proceeds of a life insurance policy may be made payable to a testamentary trust. Va. Code Sections 38.1-408.1 and 38.1-442.1 (Repl. vol. 1986). See also Md. Estate and Trust Code Sec. 11-105(c) (1974). The proceeds may be paid to a testamentary life insurance trust either through the estate or

directly. If the proceeds are payable to the insured's estate and the estate is required to pay them to the trust, they are subject to the claims of the grantor's creditors, possibly depleting an important source of liquidity. In many states having inheritance taxes, furthermore, both direct payment to the trust and payment through the estate often results in a loss of the exemption for life insurance proceeds, since neither the estate nor the testamentary trust is a "named beneficiary."

- (2) Designation of trust as beneficiary. The grantor need not give the policy to the revocable trust, but merely designate it as the policy beneficiary.
- (3) Funding. The policy designation itself appears to be an adequate corpus to create the trust. Va. Code Sec. 64.1-73(b) (Repl. vol. 1987). Nominal funding, however, is always a good idea. See also N.Y. Estates, Powers & Trusts Law Sec. 13-3.3 (1967).
- (4) Estate tax savings. While the proceeds are includible in the insured/grantor's gross estate under IRC Sec. 2042, a well drafted trust can prevent their subsequent inclusion in the estate of the surviving spouse, to the extent that the proceeds are otherwise sheltered from tax by the insured's unified credit.
  - (a) Beneficiary's powers. The revocable insurance trust should give the surviving spouse no powers rising to the status of a general power of appointment under IRC Sec. 2041. Therefore, the surviving spouse (as beneficiary and as trustee), may have the right to all of the trust's income, the right to distributions of corpus as required

for the spouse's "health, education, support and maintenance," and the noncumulative right to a corpus distribution equal to the greater of five percent of corpus or \$5,000.

- (b) A/B Insurance Trust. If the estate is planned to achieve an optimum estate tax marital deduction, the insurance can be used to fund the by-pass or B trust, as noted above, or it can be used to fund the marital or A share of the estate. As is noted above, the revocable trust is one way to assure that the form of the insurance benefit qualifies for the estate tax marital deduction. See supra.
  - (c) Liquidity. The liquidity of the surviving spouse's estate can be assured by directing the trust to lend money to the spouse's estate, secured by estate assets, and to purchase estate assets (at no gain to the estate, which has received a step-up [or down] in basis under IRC Sec. 1014). This same direction can be given with respect to the estate of the insured, to provide liquidity to pay estate taxes. This method of providing liquidity is also superior to merely designating the spouse or children as the policy beneficiaries, since beneficiaries sometimes cease their willingness to provide funds to the estate, while the trustee can be directed to make such provision.
- (5) Trustee selection. The insured or the insured's spouse may certainly be the trustee of a revocable trust during the insured's lifetime. The selection of the trustee for post mortem management depends on the usual criteria of trustee selection, including financial acumen, reliability, and solvency.

- (6) Trustee's fees. Trustees rarely charge any significant fee for managing a revocable trust funded only with a policy beneficiary designation, until after the grantor dies, when the standard fee schedules used by corporate fiduciaries come into play.
- (7) Policy owner. Either the insured should maintain ownership of the policy on his or her own life (and merely designate the trust as the beneficiary), or the policy can be assigned to the trust.
- (a) The insured's spouse should not be given the policy. An assignment of the policy to the insured's spouse is a taxable gift (though eligible for the annual exclusion and marital deduction).
- (b) A gift of the policy to the insured's spouse can, in case of the spouse's premature death, return the policy to the insured's gross estate through direct bequest to the insured or through bequest to a testamentary trust of which the insured is the trustee and a beneficiary. See Rev. Rul. 84-179, 1984-2 C.B. 195.
- (8) Spouse ownership and the revocable trust. In Estate of Margrave v. Comm'r, 71 T.C. 13 (1978), acq. 1981-1 C.B. 1, aff'd 618 F. 2d 34 (8th Cir. 1980), the courts held that the insured husband had no incidents of ownership over a life insurance policy owned by his wife when the beneficiary was the husband's revocable life insurance trust. The courts held that the husband had a mere "power over an expectancy subject to the absolute whim of the policy owner." See generally also Eliasberg, "Estate of Robert B. Margrave and the Estate Taxation of Life Insurance--Incidents of Ownership Revisited," 57 TAXES 615

(1979); Katzenstein, "Use of Insured's Trust as Beneficiary Inadvisable Despite Recent Decision," 6 ESTATE PLANNING 20 (1979); and Pearle, "Spouse-owned Policy Payable to Decedent's Revocable Trust," TAX MGMT MEMO. No. 78-26, p. 3 (1978).

- (a) However, in Rev. Rul. 81-166, 1981-2 C.B. 477, the IRS agreed with Margrave but, on identical facts, said that the spouse's designation of the revocable trust as the beneficiary was an incomplete gift to the trust's other beneficiaries, and that the gift was completed when the insured died and the proceeds were paid to that trust. Thus, when the insured died, the spouse-owner was deemed to have made a completed gift to the other trust beneficiaries of a share of the proceeds.
  - (b) Also, in Rev. Rul. 81-166, the IRS said that when the beneficiary was a nonmarital trust in which the surviving spouse had an income interest, the surviving spouse's deemed gift to the trust was tied to a retained income interest, bringing the trust fund into the surviving spouse's own gross estate under IRC Secs. 2036 and 2038.
- c. The revocable retirement plan death benefit trust. It is common for individuals to seek assurance of competent future management for their retirement plan death benefits under a corporate or other retirement benefits through either annuity distributions or the use of a trust. A revocable retirement plan death benefit trust is one good method for accomplishing this result.
  - (1) Estate taxation. Qualified plan death benefits are fully includible in the deceased participant's gross estate, regardless of to whom they are paid. Thus, payment to a revocable trust

can neither present nor solve any estate tax problems.

- (2) Document efficiency. The same revocable trust can serve as a revocable life insurance trust, a revocable retirement plan death benefit trust, and the bypass (non-marital) trust in a marital deduction estate plan.
- (3) Testamentary trusts. It is unclear whether Virginia statutorily authorizes payment of retirement plan death benefits to a testamentary trust. Va. Code Sections 38.1-408.1 and 38.1-442.1 (Repl. vol. 1986) authorize designation of a testamentary trustee as the beneficiary of life insurance proceeds, and Va. Code Sec. 38.1-408.1 (Repl. vol. 1986) says that the term "policy of life insurance" is to be construed to include other types of contracts under which proceeds become payable on the testator's death. Does this include retirement plan death benefits? If retirement benefits are payable to a testamentary trust under an ineffective designation, the benefits will be deemed payable to the participant's estate and will become taxable, regardless of their form. In the absence of clear state law validating the use of testamentary trusts, estate taxes can still be avoided by paying the benefits to an executor who is required (under the will) immediately to pay the proceeds into the trust and not to make them available for the satisfaction of the estate's other obligation. See Rev. Rul. 73-404, 1973-2 C.B. 319; and "Estate of Perlick v. United States, 31 AFTR 2d 73-1437 (E.D. Wis. 1973).
- (4) Income in respect of a decedent. Lump sum and other retirement plan death benefits that are includible in the participant's gross estate are income in respect of a decedent (I.R.D.) subject

to full estate and income taxation.  
IRC Sec. 691.

- (a) I.R.D. deduction. The estate or recipient beneficiary gets an income tax deduction for the estate taxes paid on the I.R.D. IRC Sec. 691(c).
  - (b) Interaction with the marital deduction. The I.R.D. deduction is computed on the basis of the additional amount of estate taxes due because of the inclusion of the I.R.D. in the gross estate, so the deduction may be reduced if the retirement benefits are paid to the surviving spouse in a form qualifying for the marital deduction, and if more than half of the I.R.D. is included in the marital deduction share of the estate (or the I.R.D. is included in an underfunded marital deduction share). Payment to a revocable trust with by-pass powers does not qualify for the marital deduction and maximizes the I.R.D. deduction. See Hastings, "Income in Respect of a Decedent: A New Look Under the Tax Reform Act of 1976 and the Revenue Act of 1978," 37th N.Y.U. INST. ON FED TAX. Sec. 43.03 (1979).
- (5) Retirement Equity Act. The Retirement Equity Act of 1984 prevents designating anyone other than a surviving spouse as the beneficiary of a qualified plan death benefit, without the spouse's express written consent. The waiver must either be notarized or witnessed.
  - (6) 5-Year Payout. IRC Sec. 401(a)(9) requires that the plan provide for a full payout within five years after a participant's death, or if payable to a "designated beneficiary," a payout over the beneficiary's life expectancy. It is unclear whether a revocable trust may

be a designated beneficiary exempt from the 5-year mandatory payout requirement.

- (6) State law questions. It is not clear, absent a governing statute, whether a revocable trust may be designated as the beneficiary of a retirement plan death benefit. See Calif. Prob. Code Sec. 6321 (Supp. 1987) and Md. Estates and Trust Code Sec. 11-105(b) (1974). However, the same argument made with respect to a testamentary trust can be applied to contend that Virginia law (Va. Code Sec. 38.1-408.1 (Repl. vol. 1986)) authorizes payment of a retirement plan death benefit to a revocable trust, particularly in light of the separate provision of Va. Code Sec. 64.1-73 (Repl. vol. 1987). It is unlikely that a mere retirement plan beneficial designation is sufficient corpus with which to fund a revocable trust, and additional corpus should be used. See, however, Md. Estates and Trusts Code Sec. 11-105 (1974).
- (7) Authorizing documents. The retirement plan instrument should specifically authorize the designation of a trust as the beneficiary of a participant's death benefits.

B. Protecting the Settlor's Assets.

1. General. A revocable trust can be used to protect the grantor's assets from the importunities of others. Thus, a revocable trust may be able to insulate the grantor's assets (or specific assets) from the claims of the grantor's spouse, creditors and sometimes children.
2. Claims of Creditors. The claims of the grantor's creditors cannot be defeated by placing the grantor's assets in a revocable trust. The details of the creditors' rights are dictated by state law.
  - a. Virginia. Va. Code Sec. 55-19 (Repl. vol. 1986) authorizes spendthrift trusts of up to \$500,000, and it does not specifically rule out the grantor being the beneficiary, except to the extent that such a trust cannot operate to prejudice any existing creditors of the grantor. See *Alderman v. Virginia Trust Co.*, 181 Va. 497, 25 S.E. 2d 333 (1943); *Hutchinson v. Maxwell*, 100 Va. 169, 40 S.E. 655 (1902); *Sheridan v. Krause*, 161 Va. 873, 172 S.E. 508 (1934); and *Rountree v. Lane*, 155 F. 2d 471 (4th Cir. 1946).
  - b. Other states--generally. In some other states, both present and future creditors can attach the assets of such a trust. See N.Y. Estates, Powers & Trusts Law Sec. 7-3.1 (1967). In some, the power to revoke is equated with the ownership of the trust corpus, for this purpose. See Kan. Stat. Sec. 58-2414 (1976); and Ohio Rev. Code Sec. 1335.01 (1979). This is particularly important if the grantor is not a beneficiary of the trust. See RESTATEMENT Sec. 330; also see *Matter of Granwell*, 20 N.Y. 2d 91, 228 N.E. 2d 779 (1967).
  - c. Transfers in defraud of creditors. Typically, the trust will be ignored if the transfer to the trust was in defraud of the grantor's creditors. See Va. Code Sec. 55-80 et seq. (Repl. vol. 1986); and the Uniform Fraudulent Conveyances Act, adopted in 25 states.

- d. Trustee in bankruptcy. A trustee in bankruptcy can always reach the assets of a revocable trust to pay the claims of the bankrupt's creditors. 11 U.S.C. Sec. 110a (1976).
3. Defeating the elective rights of a surviving spouse. A widow has a right in all states (except some community property states) to renounce the decedent's will and take a statutory share or common law dower. In some states, a surviving husband has similar rights. In Virginia, both have the right to a statutory share. Normally, however, these rights extend to the decedent's probate assets only and, since the assets held in a revocable trust are not probate assets, the question is raised whether they may be reached by the surviving spouse. Generally see "The Revocable Living Trust as an Estate Planning" (Report of the Committee on Estate and Tax Planning), 7 REAL PROP., PROB. & TR. J. 223, 237 (Summer 1972); Russo & Kirkwood, "The Use of a Revocable Trust to Defeat the Elective Share," 57 FLA. BAR J. 110 (1983); and Daniel M. Schuyler, "Revocable Trusts--Spouses, Creditors and Other Predators," 8th MIAMI INST. ON EST. PLAN. ch. 74-13 (1974).
- a. Old Massachusetts rule. In *Kerwin v. Donaghy*, 317 Mass. 559, 59 N.E. 2d 229 (1945), the Supreme Judicial Court of Massachusetts held that a grantor could defeat his wife's elective rights by placing all of his assets in a revocable trust, though the court acknowledged that the revocable trust had been established to defeat the wife's rights.
    - (1) Virginia. There appears to be no definitive Virginia law on this point, but see *Hall v. Hall*, 109 Va. 117, 63 S.E. 420 (1909) (deceased put assets in trust with retained life estate and court held that he could defeat his wife's dower right by irrevocably transferring the property, even if he retained a life estate.)

- (2) States following Massachusetts. A number of states have followed the Massachusetts rule.
- (a) Arkansas. *Richards v. Worthen Bank & Trust Co.*, 261 Ark. 890, 552 S.W. 2d 228 (1977).
  - (b) Connecticut. *Cherniack v. Home National Bank & Trust Co. of Meridian*, 151 Conn. 367, 198 A. 2d 58 (1964);
  - (c) District of Columbia. *Windsor v. Leonard*, 475 F. 2d 932 (1973).
  - (d) Illinois. *Toman v. Svoboda*, 349 N.E. 2d 668 (Ill. Ct. App. 1976); *Smith v. Northern Trust Co.*, 322 Ill. App. 168, 54 N.E. 2d 75 (1944); *Johnson v. LaGrange Bank*, 365 N.E. 2d 1056 (Ill. 1977).
  - (e) Indiana. *Leazenby v. Clinton County Bank & Trust Co.*, 355 N.E. 2d 861 (Ind. Ct. App. 1976).
  - (f) Kentucky. *DeLeuil's Executors v. DeLeuil*, 255 Ky. 406, 74 S.W. 2d 474 (1934).
  - (g) Maryland. *Windsor v. Leonard*, 475 F. 2d 932 (D.C. Cir. 1973) (applying Maryland law); *Whittington v. Whittington*, 205 Md. 1, 106 A. 2d 72 (1954); *Brown v. Fidelity Trust Co.*, 126 Md. 175, 94 A. 523 (1915).
  - (h) Michigan. *Rose v. Union Guardian Trust Co.*, 300 Mich. 73, 1 N.W. 2d 458 (1942).
  - (i) Utah. *Horn v. First Security Bank*, 548 P. 2d 1265 (Utah. 1976).
  - (j) Vermont. *Dunnett v. Shields*, 97 Vt. 419, 123 A. 626 (1926).

- (k) West Virginia. Davis v. KB&T Co.,  
309 S.E. 2d 45 (W. Va. 1983).
- (3) States Rejecting the Old Massachusetts rule. Other states, including Massachusetts itself, have specifically refused to follow the Old Massachusetts rule.
- (a) Kansas. Ackers v. First National Bank of Topeka, 192 Kan. 319, 387 P. 2d 840 (1964), reh. denied 389 P. 2d 1 (1964).
  - (b) Massachusetts. Sullivan v. Burkin, 460 N.E. 2d 572 (Mass. 1984).
  - (c) Missouri. Wanstrath v. Kappel, 356 Mo. 210, 201 S.W. 2d 327 (1947).
  - (d) North Carolina. Moore v. Jones, 261 S.E. 2d 289 (N.C. Ct. App. 1980).
  - (e) New York. MacGregor v. Fox, 280 App. Div. 435, 114 N.Y. 2d 286 (1952), aff'd 305 N.Y. 576, 111 N.E. 2d 445 (1953); Newman v. Dore, 275 N.Y. 371, 9 N.E. 2d 966 (1937).
  - (f) Ohio. Purcel v. Cleveland Trust Co., Ohio App. 2d 235, 217 N.E. 2d 876 (1965); Harris v. Harris, 147 Ohio St. 437, 72 N.E. 2d 378 (1947); Bolles V. Toledo Trust, 144 Ohio St. 195, 58 N.E. 2d 381 (1944).
  - (g) Pennsylvania. Estate of Pengelly, 374 Pa. 358, 97 A. 2d 844 (1953).
  - (h) Tennessee. Sherrill v. Mallicote, 57 Tenn. App. 241, 417 S.W. 2d 798 (1967).
- (4) Uniform Probate Code. Section 2-202 of the U.P.C. extends the elective rights of a surviving spouse to the "augmented estate," which includes the value of any property transferred by the decedent

during his or her lifetime for less than adequate consideration in money or money's worth, over which the deceased retained a power to revoke or an income interest. See similar statutory provisions in N.Y. Estates, Powers & Trusts Law Sec. 5-1.5 (1967). Also see Kurtz, "The Augmented Estate Concept Under the Uniform Probate Code: In Search of an Equitable Elective Share," 62 IOWA L. R. 981 (1977); Note, "Widow's Election Under the Augmented Estate," 57 NEB. L. R. 146 (1978).

- (5) Adopting another state's rule. In states like Virginia, which have no rule, or states which have a rule favorable to the elective rights of the surviving spouse, it may be possible to defeat the spouse's rights through a revocable trust established in Massachusetts (or another state following the Massachusetts rule). Obviously, the rules governing conflicts of laws of various states would be relevant in determining the law governing construction of the trust, but there is case law in some states authorizing such forum shopping. See *Matter of Clark*, 21 N.Y. 2d 478, 236 N.E. 2d 152 (1963); and compare with *National Shawmut Bank v. Cumming*, 325 Mass. 457, 91 N.E. 337 (1950). No clear authority exists, however, regarding the establishment by a grantor residing in state B (rejecting the Massachusetts rule) of a trust in state A (following the Massachusetts rule), funded with real property located in state C (rejecting the Massachusetts rule).
4. Defeating the elective rights of a child. In Louisiana and some foreign countries, children have a right to a statutory share of the estate of a deceased parent. This is known as a "forced heirship." See La. Civ. Code Sections 1493-5, 1502 (1952, Supp. 1987). A revocable trust might also be used to defeat a forced heirship, though there is no case law on this point and one would

probably have to analogize to the cases on defeating the rights of a surviving spouse. See *Watts v. Swiss Bank Corporation*, 27 N.Y. 2d 270 (1979), in which the elective forced heirship under foreign law was not cut off by a revocable trust because of applicable conflicts of laws principles. See also *Estate of Renard*, 56 N.Y. 2d 973 (1982), in which a New York court refused to decline jurisdiction and stated that a New York court could refuse to enforce the rights of forced heirship created under French law, when a testator with substantial New York connection wrote a pair of situs wills, leaving little to her children.

C. The Funded Revocable Trust as a Will Substitute.

1. General. Restraint should always be exercised in discussing the use of a funded revocable trust as a will substitute since it is a popular misconception that a revocable trust makes a fine complete will substitute. In reality, a revocable trust is rarely a complete will substitute since it is only in a very unusual circumstance that the grantor's entire assets are placed in the trust, if for no other reason than the fact that assets are constantly being acquired and disposed of.
2. The necrophobic client. A funded revocable trust may be a good will replacement when a client is unwilling to execute a property will from the apparently common belief that contemplation of one's own mortality hastens in some way the date at which such documents cease to be ambulatory. Suggest, instead, a "living trust", and some of these clients will consent to executing the documents. See Edward Schlesinger, "Seven Case Histories of the Revocable Trust," 5TH MIAMI INST. ON EST. PLAN. ch. 71 (1971).
3. Avoiding probate. One of the major reasons a funded revocable trust is often suggested is the avoidance of probate. Generally, this is not a sufficient reason since most probates are quick, relatively inexpensive, and serve the useful purpose of clearing title to all estate assets. See e.g., Malcolm A. Moore, "The Advantages of Probate," 10TH MIAMI INST. ON EST. PLAN. ch.76

(1976). However, sometimes avoiding probate (in whole or for certain assets) is still advisable.

- a. Avoiding post probate court supervision. The best reason for using a funded (or unfunded) revocable trust is the avoidance of on-going court supervision, which may be expensive and time-consuming. Va. Code Sec. 26-17 (Repl. vol. 1985). However, see Will of Reed, 91 Misc. 2d 997, 399 N.Y.S. 2d 101 (Surr. Ct. 1977); Matter of Fornason, 88 Misc. 2d 736, 389 N.Y.S. 2d 1003 (Surr. Ct. 1976); and Matter of Frohlich, 87 Misc. 2d 518, 385 N.Y.S. 2d 922 (Surr. Ct. 1976), holding that a New York Surrogates court had jurisdiction over funded revocable trusts when the terms of the trusts intimately concern the "affairs of decedents." See also Renee R. Roth, "New Legislation Affecting Estates, Trusts," 184 N.Y.L.J. 1 (November 24, 1980).
- b. Accountings. Va. Code Sec. 26-17 (Repl. vol. 1985) requires accountings for a "personal representative, guardian, curator, committee, testamentary trustee, trustee under Sec. 37.1-134, and receiver under Sec. 55-44." This is deemed to exempt trustees of inter vivos trusts unless the trustee is required to qualify (e.g., a trustee for a mentally ill person, under Va. Code Sec. 37.1-134 (Repl. vol. 1985)). The revocable trust can avoid the problems raised by judicial accountings for minor beneficiaries by requiring the trustee to account only at specific times and for the adult beneficiaries and the guardians of the minor beneficiaries. While Virginia law is silent on this point, the laws of some states permit informal accounts. See, e.g., N.Y.S.C.P.A. Sec. 2202 (1967); or see Tex. Prob. Code Sec. 145 (1980), greatly simplifying the accounting when an "independent trust administration" is authorized.
- c. Small businesses. If the decedent owns a proprietorship which cannot be continued by the family, it may be necessary to arrange a prompt sale after the date of death to avoid a substantial diminution in value. In such

cases, even the relatively minor delays of probate should be avoided, and the business may be held in a revocable trust.

- d. Ancillary administration. If the decedent owns property in another state, an ancillary administration may be avoided by putting the property in a revocable trust the situs of which is the state of the decedent's domicile.
  - (1) Alternative. Obviously, this is not the only way to achieve this result, and incorporation or a family partnership should also be considered.
  - (2) Double domicile problems. This use of a revocable trust also may avoid the problem of establishing a dual domicile, which can result in double or other multiples of inheritance taxes. See *Estate of Dorrance*, 333 Pa. 162, 3 A. 2d 682 (1931), cert. denied 287 U.S. 660 (1932); *In re Dorrance*, 115 N.J. Eq. 268, 170 A. 743 (1934); *Dorrance v. Martin*, 116 N.J. Eq. 362, 184 A. 601 (1935), cert. denied 298 U.S. 678 (1936). See also *Texas v. Florida*, 306 U.S. 398 (1938).
- e. Passive assets. Certain estate assets do not require probate administration because of their highly passive character. If the grantor owns contract rights, such as death benefits, royalty rights, and unpaid installment obligations, these may be kept out of probate through a revocable trust.
- f. Will contests. A revocable trust may be useful to avoid a will contest based on undue influence or incompetency.
  - (1) Continuing management. The ongoing management of the trust tends to dispute any claim of incompetency (or, one supposes, to support it if the management is done in a totally incompetent manner).

- (2) Practical difficulty of such challenges. While the trust is not legally any less susceptible to challenge, as a practical matter challenge is more difficult. To challenge the provisions of a revocable trust, the heir must find out the contents of the trust and institute a separate legal action (rather than merely intervening in the probate). This is even more complicated for the contestant if the trust is located in another state. To contest a will the individual merely brings a bill to impeach. Va. Code Sec. 64.1-88 (Repl. vol. 1987).
  - (3) Alternative. Consider also the execution of sequential, annual wills, all containing the same provision, to show that the dispositive provisions actually represented the testator's desires. Jeffrey L. Crown, "Thwarting the Will Contest--Some Psychological Aspects of Will Drafting and Execution," 1980-1 TAX MGMT. EST., GIFTS & TR. J. 25 (January-February 1980).
- g. Publicity. Wills are recorded in Virginia and, therefore, become public knowledge. Va. Code Sec. 64.-94 (Repl. vol. 1987). A funded revocable trust also avoids the publicity of probate, which may be important if the deceased is a celebrity or if the terms of the will are embarrassing to some members of the family. Avoiding publicity may also be important in staving off "gold-digging" suitors for the surviving spouse and children, and in providing for illegitimate children or paramours.
- (1) Inheritance tax publicity. In some states, the revocable trust does not entirely assure the desired privacy because, not only must the decedent's federal estate tax return be included with the state inheritance tax return, but the state return is made public. See e.g., Rev. Rul. 70-454, 1970-2 C.B. 296, superseding Rev. Rul. 55-238, 1955-

1 C.B. 335. In Virginia, while there is no inheritance tax, the former inheritance tax laws assure privacy of tax returns. Va. Code Sections 58-46 and 58-46.1 (Repl. vol. 1986). It is not clear whether these apply to the present Virginia estate tax return.

- (2) Be careful about making a spouse the personal representative if he or she is not to know the terms of the revocable trust, since a copy will be required with the federal estate tax return.
- h. Unclear probate laws. A funded revocable trust is a fine method by which to avoid being a test case of a new state probate code.
- i. Mortmain statutes. Many states (though not Virginia, see Va. Code Sections 55-26 et. seq. and 57-7 (Repl. vol. 1986)) have mortmain statutes precluding charitable bequests in wills which are executed within a specified time of the date of death. These statutes do not normally apply to transfers by a revocable trust, enabling one to defeat their application.
  - (1) Validity. There are serious questions about the continued validity of such statutes. See Estate of French v. Doyle, 365 A. 2d 621 (D.C.Ct. App. 1976) (holding the D.C. statute unconstitutional); and Note: "Mortmain Statutes: Questions on Constitutionality," 52 NOTRE DAME LAWYER 638 (1977).
  - (2) Alternatives. Some states, such as New York have mortmain statutes which merely provide that other beneficiaries can challenge a charitable bequest if they receive less because of the bequest. In such states, the practice is, rather than establishing a revocable trust, to provide that if the bequest is voided, the gift passes to an individual not otherwise a beneficiary. This eliminates all possible challenges.

D. Choice of a Situs.

1. General. A revocable trust can also be used to allow the grantor to select the situs of administration and disposition of certain assets, a benefit not otherwise enjoyed with property is disposed of testamentarily. See generally RESTATEMENT OF CONFLICTS OF LAW, Secs. 241, 294(1).
2. Establishing trust situs. The situs of a trust and the law governing its application may be determined by the location of the trust corpus, the residence of the trustee, and statements contained in the trust instrument. Consequently, it is normally possible to "adopt" another state's law with respect to realty located in that state and with respect to personalty held in a trust in that state, by having a local fiduciary and by stating in the trust agreement that the trust law of the desired state is to govern.
3. Objectives. There are many benefits derived from placing the situs of the trust in another state:
  - a. Selection of fiduciary. If an out-of-state corporate fiduciary is desired, it should be possible to avoid provisions like Va. Code Sec. 26-59 (Repl. vol. 1985) by the use of a funded revocable trust established in another state.
    - (1) Validity. See *Fain v. Hall*, 463 F. Supp. 661 (M.D. Fla. 1979) (holding unconstitutional a Florida statutory prohibition against nonresident non-family members serving as executor); and *BT Investment Managers, Inc. v. Lewis*, 461 F. Supp. 1187 (N.D. Fla. 1978) (holding unconstitutional a Florida statutory prohibition against nonresident corporate fiduciaries); but also see *In re Emery*, 59 Ohio App. 2d 7, 391 N.E. 2d 746 (1978) (holding constitutional Ohio's statutory requirement that executors and administrators be domiciled in the state).

- (2) Pour-overs. If the will pours over into the revocable trust, Virginia law requires a resident fiduciary. Va. Code Sec. 64.1-73(a)(3) (Repl. vol. 1987).
- b. Defeat of spouse's rights. As has been noted, this may permit the defeat of the elective rights of a surviving spouse.
- 4. Tax problems. Be careful in selecting the situs of a revocable trust since not all states adopt the Federal (and Virginia) concept of a grantor trust for income tax purposes. If the grantor resided in Virginia, a state that uses the grantor trust concept, but the trust is situated in a state that does not recognize this concept, the result is double income taxation of the trust income. Generally, see Brian M. Freeman, "State Power to Tax Trust Income on Basis of Settlor's or Grantor's Residence or Domicile," 53 TAXES 237 (April 1975); and on the constitutionality of double state individual income taxation, see *Curry v. McCanless*, 307 U.S. 357 (1939).
- 5. Foreign trusts. A revocable foreign trust may offer the ability to invest in certain securities not otherwise available in the United States, and to use certain foreign fiduciaries not licensed in the United States. Transfers of appreciated property to such trusts are not initially subject to the 35 percent excise tax on appreciation under Rev. IRC Sec. 1491, but they might be subject when the grantor dies. See Rev. Rul. 87-61, IRB 1987-28, p. 11 (1987). See generally Zaritsky, Tax Management No. 416 FOREIGN TRUSTS (1980).

E. Improving Estate Liquidity.

- 1. Family Liquidity. A revocable trust better provides for post mortem family liquidity than mere ownership of liquid assets, because its assets are not tied up in probate and may be used immediately to provide needed funds.
- 2. Pour-Back Trusts. A revocable trust may also be required to pour assets back to the estate, providing estate liquidity. See also Raymond L. Sutton, Jr., "The Use of Pour-Back Provisions in a

Revocable Trust," 1980-3 TAX MGMT ESTATES, GIFTS & TR. J. 4 (1980).

3. Flower bonds. To maximize the benefits of buying and holding flower bonds, they should be purchased close to the date of death. This can be accomplished well either through a durable power of attorney or the use of a revocable trust.
  - a. Durable power of attorney. Durable powers of attorney may be exercised by the attorney-in-fact even after the incompetency of the grantor. Flower bonds purchased under such a power are still viewed as owned by the deceased and still are redeemable in payment of estate taxes.
    - (1) Virginia recognizes durable powers of attorney. Va. Code Sec. 11-9.1 (Repl. vol. 1985).
    - (2) There is substantial case law to the effect that flower bonds purchased under a nondurable power of attorney are still redeemable in payment of estate taxes. See e.g., *Estate of Pfohl v. Commr*, 70 T.C. 630 (1978); and see *Estate of Watson v. United States*, 442 F. Supp. 1000 (S.D.N.Y. 1977), rev'd for lack of subject matter jur. 586 F. 2d 925 (2d Cir. 1978).
  - b. Revocable trust. Treasury regulations permit redemption of flower bonds purchased by a revocable trust even if the grantor was incapacitated at the time of the purchase, as long as the trustee is expressly and unconditionally required to use the funds to pay the grantor's estate taxes, the trust terminates in favor of the estate (a pour-back), or state law apportions a share of the taxes to the trust. 31 C.F.R. Sec. 306.28(a), (b), (c); Form PD 1782, Schedule T. Virginia law apportions taxes to a revocable trust's assets. Va. Code Sections 64.1-161, 64.1-162 (Repl. vol. 1987).

- (1) Trust clauses: When a revocable trust is used to purchase flower bonds, either:
  - (a) The will should direct the executor to certify to the trustee the amount of estate tax liability, and exculpate the trustee when he or she relies on this certification; or
  - (b) Alternatively, the trust documents can direct the trustee to turn over all bonds to the executor, subject to margin loans, for payment of the estate taxes.
- (2) Valuation. Flower bonds held by a revocable trust are valued, for estate tax and basis purposes, at their fair market value on the date of death. If the bonds are available for payment of estate taxes, their fair market value is their face amount. If they are not usable for payment of estate taxes, their fair market value is the discounted market price. In Private Letter Ruling 7934060, flower bonds were held in a typical combination revocable marital and non-marital trust and the trustee had the power to fund the different sub-trusts with whichever assets he chose. The taxes were only paid from the non-marital share and not from the marital share. The I.R.S. ruled privately that all of the bonds were valued at their face amount, no matter to which share they were allocated, since all could have been used to pay estate taxes.

### III. DRAFTING, EXECUTING AND FUNDING THE REVOCABLE TRUST.

- A. Drafting the Revocable Trust. Revocable trusts require surprisingly careful drafting, though it is certainly easy to correct errors, if caught prior to the grantor's demise.
1. Application of income. Payment or application of income to the grantor should be directed expressly, though a discretionary accumulation power may be granted in the event of the grantor's disability.
  2. Distributions of principal. Discretion should be granted to use principal for the grantor's benefit. A power may also be given the trustee to sprinkle principal among other beneficiaries in the event of the grantor's disability, to permit continued estate reduction. The trustee may even be directed to maintain a charitable gift program in case of the grantor's extended disability.
  3. Insurance powers. The grantor should generally reserve all rights over the insurance policies, though the trustee may be granted limited powers with respect to those policies payable to the trust.
  4. Tax clauses.
    - a. Flower bonds. If the trust will hold flower bonds, the trustee should be empowered to use the bonds to pay estate taxes, to assure their redeemability.
    - b. Secondary pour-back. The trustee may be directed to deliver all assets, other than death benefits, to the executor, to the extent that the residuary estate is insufficient to pay death taxes, funeral and administration expenses, and other estate obligations.
      - (1) There should be a correlative provision in the will requiring the executor to certify the amount of the insufficiency to the trustee.

- (2) The trust should absolve the trustee from any liability if the trustee relies on the executor's certification and should relieve the trustee of any duty to assure that the executor uses the funds for payment of the certified expenses. The trustee is absolved of liability statutorily, to the extent he or she relies on the accounts of the personal representative who pours-over assets from the estate to the trust. Va. Code Sec. 26-5.1 (Repl. vol. 1985).
5. Rule against perpetuities. The rule against perpetuities begins to run from the time the power to revoke the trust terminates or expires (normally, the grantor's death), rather than from the creation of the trust. The measuring lives need not be in existence until the power to revoke terminates, and the 21 year period runs from that date. Gray, RULE AGAINST PERPETUITIES Sec. 201 (4th ed. 1942). Of course, this is less a problem in Virginia, where the "wait-and-see" approach has been adopted.
6. Lapse. Virginia's anti-lapse statute applies to bequests passing upon the termination of an inter vivos trust which receives a pour-over bequest. Va. Code Sec. 64.1-64 (Repl. vol. 1987). Like most state anti-lapse statutes, however, it does not apply transfers under a funded revocable trust. Therefore, it is important to spell out in the trust agreement what happens when a beneficiary predeceases the grantor.
7. Trustee compensation. Virginia law provides that the fiduciary of a trust or estate may be allowed "reasonable compensation." Va. Code Sec. 26-30 (Repl. vol. 1985). It is useful to provide guidelines for the compensation of the revocable trust's fiduciary, such as reference to a corporate fiduciary's regular fee schedules, or to compensation based on the trustee's normal hourly rates.
  - a. Pour-back problems. If the trust pours-back to the estate, there may be a double fee. The trustee may receive a termination fee for ending the trust, and the executor may

receive a fee based, at least in part, on the size of the estate, augmented by the former trust corpus. This entire fee is deductible for estate tax purposes as an estate administration expense. See *Estate of DeFoucancourt v. Comm'r*, 62 T.C. 485 (1974).

8. Accountings. The requirement that trustees must file annual statements of receipts and disbursements within four months after the end of each year does not apply to revocable trusts. Va. Code Sections 26-17, 26-18 (Repl. vol. 1985). However, the beneficiaries have a basic common law right to an accounting from the trustee, upon filing of a petition in court. While it is not possible to entirely eliminate these accountings, it may be possible to limit them. See e.g., *Briggs v. Crowley*, 352 Mass. 194, 224 N.E. 2d 417 (1967).

- a. While the grantor is alive, the trustee should be required to make accountings only to the grantor, and only upon the grantor's request.
- b. After the grantor's death, only informal accountings should be required to be made to any person who may be entitled to a distribution of income or corpus.

B. Executing and Funding the Revocable Trust. Generally, there should be no serious problems in executing and funding a revocable trust, under Virginia law.

1. Pour-overs. Under Virginia's version of the Uniform Testamentary Additions to Trusts Act, a will can pour-over into a revocable if the trust is identified in the testator's will and its terms are set forth in a written instrument executed (and, therefore, in existence) before the will or concurrently with the will. Va. Code Sec. 64-1.73(a)(1), (2) (Repl. vol. 1987).

- a. "Concurrently." The meaning of concurrently is unclear. Does the grantor have to be ambidexterous? Probably, it means that the execution of the two documents is done as part of the same ceremony.

- (1) On prior law requiring trust to pre-date will, see *Clark v. National Bank of Collingwood*, 38 N.J. Super. 69 (1950); *Old Colony Trust Co. v. Cleveland*, 291 Mass. 380, 196 N.E. 920 (1935), overruled *Second State Street Trust Co. v. Pinion*, 170 N.E. 2d 50 (Mass. 1960).
- b. Amended instruments. The Uniform Testamentary Addition to Trust Act in Virginia and most other states permits pour-overs to a trust that is amended after execution of the will. Va. Code Sec. 64.1-73(c) (Repl. vol. 1987).
- (1) Old rule. The older rule precluded such pour-overs. See e.g., *Atwood v. Rhode Island Hospital Trust Co.*, 274 F. 513 (1st Cir. 1924).
  - (2) When planning an estate which may have to be valid in a state which still adopts the old rule, execute a codicil to the will after each trust amendment.
- c. Revocation. If the trust is revoked prior to the date of death, the will pour-over lapses. Va. Code Sec. 64.1-73(f) (Repl. vol. 1987). It appears that if a specific bequest has been made to a revoked trust, it passes to the residuary beneficiary; if the residuary bequest has been made to the revoked trust, it passes under the law of descent and distribution. If, however, the trust is subsequently amended, rather than revoked, the will should be republished by codicil.
- d. Trustees. If the trustee of a revocable trust funded partially by pour-over and partially possessing separate trust corpus does not qualify under Virginia law, the trust does not fail and the court can treat the trust like a testamentary trust, and take whatever steps are necessary to prevent failure, such as appointing a qualified trustee. Va. Code Sec. 64.1-73(h) (Repl. vol. 1987).

2. Funding the Pour-Over Trust. A revocable trust does not begin to exist until it has a corpus, so one should normally provide some funds prior to or contemporaneously with the execution of the will.
  - a. Unfunded trusts. Virginia statutory law authorizes pour-overs to unfunded revocable trusts. Va. Code Sec. 64.1-73 (Repl. vol. 1987). However, the trust should still be funded because the testator may move to another state whose law may not be so generous.
    - (1) How much corpus is required? \$10? \$100? \$1,000?
    - (2) See Hageman v. Cleveland Trust, 45 Ohio St. 2d 178, 343 N.E. 2d 121 (1976), in which an Ohio court said that an unfunded revocable trust had no independent significance, but that it could be incorporated by reference in a will nonetheless.
    - (3) How should the nominal corpus be held? Consider savings bonds.
  - b. Revocable life insurance trusts. The Virginia Uniform Testamentary Additions to Trust Act validates a pour-over from a will to an unfunded revocable life insurance trust. Va. Code Sec. 64.1-73(b) (Repl. vol. 1987).
1. General factors. The general factors of trustee selection, including managerial and financial competency, solvency, e.g., apply to the selection of the trustees of a revocable trust, particularly the trustees to act after the incompetency or death of the grantor.
2. Residency. If the trust is to receive a pour-over from the will of a Virginia decedent, at least one individual trustee must be a Virginia resident, and all corporate fiduciaries must be authorized to do business in Virginia. Va. Code Sec. 64.1-73(a)(3) (Repl. vol. 1987). If the trust is funded independently and will not receive a pour-over bequest, foreign fiduciaries would seem to be acceptable.

3. Grantor as trustee. The grantor can be the sole trustee, as long as there is at least one other beneficiary, either present or future, to prevent merger of the legal and equitable interests and termination of the trust. The fact that the grantor may terminate the interest of the other beneficiaries by revoking the trust does not eliminate their interests for purpose of the doctrine of merger.

#### IV. TAX CONSIDERATIONS REGARDING A REVOCABLE TRUST.

##### A. Tax Considerations During the Grantor's Lifetime.

Contrary to the belief of many practitioners, revocable trusts are fraught with income, estate, gift and generation-skipping tax considerations. While most of these considerations appear to be the most critical after the grantor's death, some are of importance during the grantor's lifetime.

1. Federal income tax considerations. There are really no major income tax advantages or disadvantages in the lifetime use of a revocable trust, though there are several areas for cautious planning.

a. Grantor trust rules. The grantor of a revocable trust is treated as the owner of the trust for income tax purposes.

(1) The grantor personally takes into income all items of ordinary income and loss, as well as capital gain and loss. IRC Sec. 676; and *Campbell v. Comm'r*, T.C. Memo. 79,495 (1979), aff'd per curiam without opinion (9th Cir. 1980) (grantor taxable on income of revocable trust although power to revoke or amend not exercised for ten years).

(2) The trust cannot have a taxable year distinct from that of the grantor of the trust. Rev. Rul. 57-390, 1957-2 C.B. 326.

(3) The trust cannot have an accounting method distinct from that of the grantor. Rev. Rul. 57-390, 1957-2 C.B. 326.

b. Holding period. The holding period of assets transferred to a revocable trust includes the holding period of the assets in the hands of the grantor.

(1) Impact of irrevocability. Once the trust ceases to be revocable (usually on the grantor's death), the holding period

begins anew. Rev. Rul. 73-209, 1973-1 C.B. 614.

- (2) Impact of Revenue Ruling 73-209. The fact that a new holding period begins when the grantor dies is not normally very significant. Under IRC Sec. 1223(11), any person who acquires property from a decedent, including acquisition from a trust the corpus of which was included in the decedent's gross estate because the trust was revocable, takes a holding period sufficient to produce a long-term capital gain. However, what of the holding period of a donee of that person, or another person who takes from the initial taker in a manner otherwise producing a carryover basis?

c. Deductibility of trust expenses. The costs of establishing and maintaining a funded revocable trust should be deductible as expenses in the management and production of income. IRC Sec. 212; *Merians v. Comm'r*, 60 T.C. 187 (1973); and *Herbst v. Comm'r*, T.C. Memo. 43,055 (1943); see also generally Allington, "Deductibility of Estate Planning Fees," 60 A.B.A. J. 482 (1974). This item is, of course, subject to the new two percent floor on miscellaneous deductions, under the Tax Reform Act of 1986.

- (1) Unfunded revocable trusts. The costs of establishing and maintaining an unfunded revocable trust should be deductible only to the extent they are attributable to tax planning. See *Merians v. Comm'r*, 60 T.C. 187 (1973); and *Bagley v. Comm'r*, 8 T.C. 130 (1947) (Acq. 1947-1 C.B. 1).
- (2) Challenges. No deduction is allowed for the defense of a suit challenging the validity of a revocable trust because of the grantor's disputed competency. *Lewis v. Comm'r*, 27 T.C. 158 (1956), aff'd 253 F. 2d 821 (2d Cir. 1958).

- (3) Prepaid trustees fees. Prepaid trustees fees cannot be currently deducted, but must be amortized over the period to which they relate. Rev. Rul. 58-53, 1958-1 C.B. 152.
  - (4) Exempt income. Fees allocable to tax-exempt income are not deductible. Regs. Sec. 1.212-1(e).
- d. Sale of a residence. Generally, the tax advantages on the sale of the grantor's principal residence are retained even if the residence is held in a revocable trust.
  - (1) Residence replacement rule. Recognition of the gain on the sale of the property used as the grantor's principal residence may still be deferred under the residence replacement rule (IRC Sec. 1034) by purchase of a new residence for a price exceeding the sales price of the old residence, even if the old residence was sold during the grantor's lifetime by the trustee of a revocable trust established by the grantor. Rev. Rul. 66-159, 1966-1 C.B. 152; compare Rev. Rul. 54-583, 1954-2 C.B. 158.
  - (2) Over-55 rule. It appears that the over-55 rule (IRC Sec. 121) may still be used to eliminate up to \$125,000 of taxable gain on the sale of the principle residence of a grantor who is at least 55 years of age during the year, even if the property is held by a revocable trust at the time of the sale. Ltr. Rul. 8007050 (limited to situations in which all of the income of the trust is taxable to the grantor whose personal residence is sold or exchanged).
  - (3) Involuntary conversion. A grantor whose real estate is involuntarily converted (condemned or destroyed) can use IRC Sec. 1033, to defer recognition of gain, even if the property is held by a revocable trust. Rev. Rul. 66-159, 1966-1 C.B. 152.

- e. Installment sales. The transfer to a revocable trust of an installment obligation (IRC Secs. 453, 453B) is not a disposition of that obligation, resulting in acceleration of the deferred gain. Rev. Rul. 73-584, 1973-2 C.B. 162; Rev. Rul. 74-613, 1974-2 C.B. 153.
- (1) Return of the obligation by the trust to the grantor upon the revocation of the trust is also not a disposition. Rev. Rul. 76-100, 1976-1 C.B. 126.
  - (2) Transfer of the installment note to a revocable trust for the benefit of joint obligees (or the survivor) appears not to be a disposition of the note, as long as the obligees are both grantors of the trust under IRC Sec. 671. Ltr. Ruls. 8011060 and 7943063.
  - (3) Distribution of an installment obligation to the beneficiaries of a revocable trust would appear to be a disposition, though there are no clear precedents.
- f. Savings bonds. The transfer to a revocable trust of series E savings bonds with untaxed interests does not result in the acceleration of the deferred income. Rev. Rul. 58-2, 1958-1 C.B. 236.
- g. Percentage depletion. Percentage depletion is still available for certain proven oil and gas properties. IRC Sec. 613A. However, if these properties are transferred after 1974, the transferee loses the right to percentage depletion and is limited to cost depletion. The transfer to a revocable trust of an interest in a proven oil and gas property appears to deprive the trust (and the grantor) of percentage depletion. IRC Sec. 613A(c)(9)(iii), (vi); Prop. Regs. Sec. 1.613A-7(n), (o) (1977). But see Ltr. Rul. 8104202, holding that a trust of which the transferor is the beneficial owner is not a transferee for purposes of IRC Sec. 613A.

- h. Stock options. An employee recognizes no gain on the receipt of an incentive stock option or on its exercise, when the shares are actually received. IRC Sec. 422A. These tax advantages may be lost if the option or stock is transferred to a revocable trust.
    - (1) Exercise of the option. A stock option is qualified only if it may be exercised solely by the employee to whom it is granted, or the estate of the employee, or the someone who acquires the option by inheritance or by the reason of the employee's death. IRC Sec. 421(c)(1). A revocable trust which receives the option as part of a pour-over bequest should be able to exercise it without depriving it of qualified status, but not a funded revocable trust which receives it by lifetime gift.
    - (2) Gift of the stock. Gain is recognized on even the gratuitous disposition of the stock acquired from the exercise of an incentive stock option if the disposition is made within two years of its receipt. IRC Sec. 422A(a)(1). While it is not entirely clear, a gift of the shares to a revocable trust may be a disposition, for this purpose. See Regs. Sec. 1.425-1(c).
  - i. Returns. The trustee of every trust, including a revocable trust, must obtain a taxpayer identification number (IRC Sec. 6078) and file an income tax return (IRC Sec. 6012). However, if the grantor or his or her spouse is a trustee, the items of trust income and deduction are reported directly on the grantor's own return, and the trust uses the grantor's social security number, rather than obtaining a separate taxpayer identification number for the trust. Regs. Sec. 1.6012-3(a)(9).
2. Gift Tax Considerations. While neither the creation of a revocable trust nor its revocation and return of the property to the grantor are taxable gifts, there could arguably be a taxable gift upon

the incompetency of the grantor. On the impact of incapacity on the includibility in the holder's gross estate of the property subject to a power to revoke, see *Armata v. United States*, 494 F. 2d 1371 (Ct. Cl. 1974). On effect of incompetency on includibility of the property subject to a general power of appointment, see Rev. Rul. 75-350, 1975-2 C.B. 366; and Rev. Rul. 75-351, 1975-2 C.B. 369; and *Estate of Gilchrist v. Comm'r*, 630 F. 2d 430 (5th Cir. 1980), rev'g 69 T.C. 5 (1978) (nonacq. 1978-2 C.B. 3); *Estate of Alperstein v. Comm'r*, 613 F. 2d 1213 (2d Cir. 1979), aff'g 71 T.C. 351 (1979), cert. denied sub nom. Greenberg v. Comm'r, 446 U.S. 918 (1980); and *Pennsylvania Bank & Trust Co. v. United States*, 597 F. 2d 382 (3d Cir. 1979), cert. denied 444 U.S. 980 (1979).

3. State income tax considerations. Virginia income tax law adopts the concept of grantor trusts, treating the grantor as the owner of a revocable trust, and including all items of income, deduction, gain and loss directly in his or her own income. See Va. Code Sec. 58-151.013, (Repl. vol. 1984) which initially determines an individual's Virginia taxable income from his or her federal adjusted gross income.
  - a. Double state taxation. If a revocable trust is established with a situs in another state which does not recognize the concept of grantor trusts, there may be double state income taxation.
  - b. State homestead property tax exemptions. Virginia's authorized homestead property tax exemption for the property "owned and used" by a person 65 years of age or disabled may be inapplicable if the residence is placed in a revocable trust. Va. Code Sec. 58-760.1 (Repl. vol 1984)
  - c. Real property transfer taxes. In some localities (Montgomery County, Maryland and the District of Columbia, for example), though not Virginia, there may be transfer taxes imposed on the transfer of real property to a revocable trust. Va. Code Sec. 58-61 (Repl. vol. 1984) (recordation tax inapplicable to deeds of gift).

4. Generation-skipping transfer tax considerations.

a. Transition rule problems. No tax is imposed under IRC chapter 13, on a generation-skipping transfer from an irrevocable trust which was in existence on September 25, 1985, if the trust was not amended.

(1) The regulations on the old generation-skipping tax effective dates stated that a trust is "revocable" if its corpus would be included in the grantor's gross estate under IRC Sec. 2038. Regs. Sec. 26.2601-1(c)(1).

(2) IRC Sec. 2038 covers not only revocable trusts, but trusts subject to a power to alter, amend, or terminate. The old regs make it clear, however, that this rule does not apply if the power or interest is one which will cause such taxation only upon an event not within the grantor's control, (as with a grantor retained income trust). Regs. Sec. 26.2601-1(c)(1).

(3) A trust should not be revocable for this purpose, if the exercise of the power to revoke is subject to a condition precedent which had not occurred on September 25, 1985, even if it occurs before 1982. Regs. Sec. 26.2601-1(c)(1).

(4) Any additions or amendments made after September 25, 1985, to an irrevocable trust, which increase the generation-skipping transfer or the number of skipped generations, will destroy the protection of the entire trust. Regs. Sec. 26.2601-1(e)(2). The protection of the entire trust is lost if the trust is amended or an addition is made after September 25, 1985. The protection is not lost ratably, as is the case with irrevocable trusts. Regs Sec. 26.2601-1(e)(2).

- (5) Amendments which do not destroy the protected status of a revocable trust include:
- (a) Amendments which are basically administrative or clarifying in nature and only incidentally increase the amount of generation-skipping transfers, such as a change in the number or identity of trustees. Regs. 26.2601-1(d)(1)(i) and 26.2601-1(d)(3) (Examples 1 and 2).
  - (b) Amendments which are made to assure an existing marital, charitable, or orphan's deduction for estate, gift or generation-skipping transfer tax purposes. Regs. Sec. 26.2601-1(d)(1)(ii) and 26.2601-1(d)(3) (Examples 5).
  - (c) Amendments which only change the identity or share of existing beneficiaries, without adding younger generation beneficiaries, such as addition of an additional nephew to a class of nephews who are beneficiaries. Regs. Sec. 26.2601-1(d)(3) (Examples 10, 11, and 12).
- b. The transition rules also make the new Chapter 13 generation-skipping transfer tax inapplicable to transfers under a will in existence on October 22, 1986, if the testator dies before January 1, 1987. The Technical Corrections Act of 1987, H.R. 2636 and S. 1350, Sec. 114(g)(2), 100th Cong., 2d Sess. (1987), would extend this treatment to revocable trusts, and to wills and revocable trust whose creators died after January 1, 1987, if the creator was incompetent to change the instruments on September 25, 1985 and at all times thereafter until his or her death.

- B. Post Mortem Tax Considerations. The death of the grantor of a revocable trust completely changes the character of the trust. It ceases to be revocable and becomes a permanent trust, creating serious potential income and estate tax problems and planning opportunities.
1. Duration of the revocable trust. Upon the grantor's death, a revocable trust becomes a permanent, irrevocable trust, terminating only according to its own terms. Since the availability of various income tax planning techniques ends with the termination of the trust, careful attention should be paid to when the trust terminates.
    - a. Termination. A revocable trust normally terminates only after distribution of its assets and termination of all of its functions. Regs. Sec. 1.641(b)-3(b); Rev. Rul. 73-97, 1973-1 C.B. 404, distinguishing Rev. Rul. 57-495, 1957-2 C.B. 616.
    - b. Pour-overs. When the estate pours assets over into a revocable trust, which then divides the assets into marital and non-marital shares and terminates, the wording of the trust agreement often requires termination "upon the grantor's death" or requiring distributions "immediately upon receipt of the assets from the estate." None of these terms accelerate trust termination for estate tax purposes. Rather, they present a point of reference for ascertaining the distributive shares.
  2. Trusts vs. estates--a comparison. Many practitioners incorrectly assume that a post mortem revocable trust is taxed like the grantor's estate. There are a number of similarities in tax treatment, but also numerous distinctions in the tax treatment of these two entities.
    - a. Basis. Property received from the decedent by distribution from a revocable trust receives the same date of death (or alternate valuation date) value basis as property received directly from the estate. IRC Sec. 1014(b)(1), (b)(2).

- b. Holding period. The holding period of property received from the decedent by distribution from a revocable trust is sufficient to produce a long-term capital gain upon sale or exchange, like the holding period of property received directly from the decedent. IRC Sec. 1221(11).
- c. Taxable year. An estate may use a fiscal year, but a revocable trust (even one funded by pour-over), must adopt a calendar year. IRC Sec. 645.
- d. Accumulation distributions. Estates are not subject to the throwback rule on accumulation distributions, so income taxed to an estate will not thereafter be taxed to the beneficiaries. IRC Sec. 643(a)(3); Regs. Sec. 1.643(a)-3(a). The post mortem revocable trust is fully subject to the throwback rule.
- e. Trapping distributions. When an estate which has income distributes corpus to a simple trust, distributable net income (DNI) may be carried out. The simple trust (such as a marital deduction power of appointment trust) has income which it may not distribute, and this income is exempt from the throwback computation in connection with future distributions, unless it consists of "outside income," such as income in respect of a decedent (IRD). Regs. Sec. 1.665(e)-1A(b). Trapping distributions from a revocable trust to a simple subsidiary trust, however, are subject to the throwback rule when later distributed by the simple trust.
- f. Personal exemptions. An estate receives a personal exemption of \$600, while the exemption for a post mortem revocable trust is \$100 (for complex trusts) or \$300 (for simple trusts). IRC Sec. 642(b), (c).
- g. Estimated taxes. Estates are exempt from the requirement of quarterly estimated income taxes for the first two years. IRC Sec. 6652.

- h. Depreciated property and pecuniary bequests. If an estate or trust distributes depreciated property in satisfaction of a pecuniary bequest, a loss is realized. Under IRC Sec. 267(a)(1), however, an estate can deduct the loss but a trust cannot deduct the loss. The lost deduction can be saved by having the trustee sell the property to a third-person and distribute the cash proceeds.
    - i. Charitable "set-asides." An estate receives an income tax deduction for amounts paid or set aside for charities. A revocable trust receives no deduction for amounts set aside for charitable purposes. IRC Sec. 642(c). Therefore, when a charity is the residuary beneficiary of an estate, capital gains realized during the administration period can be deducted when set aside, but a trust recognizing such gains cannot deduct them unless they are actually paid out.
    - j. Stock options. An estate may exercise an incentive stock option without recognizing a gain, but a revocable trust which received the option by lifetime transfer cannot exercise it tax-free. However, a provision may be inserted in the stock option plan or in the option itself permitting the employee to designate an agent, such as the trustee of the revocable trust, to exercise the option after his or her death. Regs. Sec. 1.421-7(b)(2).
- 3. Planning trust income distributions. It is advantageous to permit the trustee to make discretionary distributions, rather than making it a simple trust (which must distribute all of its income annually).
  - a. Income splitting. The trust can accumulate some income and distribute some income, multiplying the taxpayers and the use of lower tax brackets and personal exemptions. Obviously, after the Tax Reform Act of 1986, the trust's compressed rate brackets and the "kiddie tax" rules applicable to beneficiaries under age 14 reduce these advantages, but they are not eliminated.

- b. Throwback problems. While estate distributions of undistributed net income (UNI) are not subject to the throwback rule, trust distributions are taxed to the beneficiaries under the throwback rule.
- (1) Distributions of UNI by a revocable trust to a subsidiary trust in the first year of the latter's existence should not be subject to throwback because there are no "preceding taxable years." Regs. Sec. 1.665(e)-1(A)(1)(i).
  - (2) Ordinarily, a simple trust (such as a marital deduction power of appointment trust) cannot make an accumulation distribution because its UNI is never attributable to a "preceding taxable year." However, simple subsidiary trust UNI attributable to "outside income," including distributions carrying out DNI from another trust (the revocable trust), is treated as attributable to a preceding taxable year. Therefore, when the simple subsidiary trust terminates, its beneficiaries may be taxed under the throwback rule. See also Charles W. Ufford, Jr., "Income Taxation of the Funded Revocable Trust After the Death of the Grantor," 30 TAX LAWYER 37 (1976).
- c. Delayed distributions. If the trust instrument does not authorize the trustee to withhold income, the trustee may still be able to do so if there is some uncertainty as to the precise distributive shares, as when estate taxes and expenses must be computed to determine the amount passing under a pecuniary formula marital deduction clause. IRC Secs. 651, 662; see also *First Trust and Deposit Co. v. Comm'r*, 41 B.T.A. 107 (1940), (nonacq. 1944 C.B. 38), aff'd 118 F. 2d 449 (2d Cir. 1941); *Central Hanover Bank and Trust Company (Work Estate) v. Comm'r*, 34 B.T.A. 741 (1936); but see also *Estate of Bryant v. Comm'r*, 14 T.C. 127 (1949), aff'd 185 F. 2d 517 (4th Cir. 1950); see also discussion in Richard B. Covey, "The Advantages and

Disadvantages of the Revocable Trust in Estate Planning," 26th N.Y.U. INST. ON FED. TAX. 1379, 1395-96 (1968); and Howard M. Zaritsky, "Special Trusts and Unique Problems: Grantor Trusts after the Grantor's Death, Alimony Trusts, and Foreign Trusts versus Domestic Trusts," 37th N.Y.U. INST. ON FED. TAX 42-1, 42-5 (1979).

- d. Timing capital gains distributions. Capital gains recognized by a post mortem revocable trust do not increase DNI unless they are allocated to income under, the trust agreement or local law, or they are actually paid to the beneficiaries. IRC Sec. 643(a)(3); Regs. Sec. 1.643(a)-3(a).

- (1) Problems of post-death appreciation. Unless the gains are allocated to DNI, the trust, and not the beneficiaries, is taxed on the gain, since there is no throwback with respect to capital gains. A pecuniary formula marital trust's share of the revocable trust corpus does not include appreciation accruing after the testator's death, and such appreciation passes to the non-marital share trust. Therefore, if corpus is distributed to the marital trust in the same year that capital gains are distributed to the non-marital trust, an inequity results because both trusts are taxed on a share of the capital gain in proportion to their shares of the revocable trust's DNI, though the capital gains really go only to the non-marital share trust. Regs. Sec. 1.662(a)-3(c).

- (2) Planning solution. The trustee of the revocable trust should withhold capital gains distributions and let the trust be taxed on the gain; then distribute the gain in a year in which no corpus distributions are made to the marital trust.

- 4. Estate inclusion. Obviously, the initial estate tax consideration is that the value of the corpus

of a revocable trust is includible in the estate of the deceased grantor. IRC Sec. 2038.

- a. Joint powers. The corpus is included in the grantor's gross estate even though the power to revoke is exercisable only in conjunction with another person, since IRC Sec. 2038(a)(1) refers to a power held by the deceased "alone or by the decedent in conjunction with any other person."
  - b. When exercisable. There is no estate inclusion unless the power to revoke was exercisable on the date of death. When a power could not be exercised without the consent of both of the grantor's children, who were also trust beneficiaries, and one of the children had predeceased, rendering revocation impossible, there was no estate inclusion in Estate of Webster v. Comm'r, 65 T.C. 968 (1977) (Acq. 1977-2 C.B. 2).
6. Trustee as executor. When a revocable trust has been used as a will substitute and it is funded with most of the grantor's property, there may be little or no probate estate and no executor appointed under local law.
- a. Who is the executor. For estate tax purposes generally, the "executor" is either the person so appointed by the will or local law (or appointed administrator), or if no such person has been appointed, "any person in actual or constructive possession of any property of the decedent." IRC Sec. 2203. This should include the trustee of a revocable trust that holds most of the decedent's assets.
  - b. Joint returns. The executor may elect to file a joint income tax return with the surviving spouse. IRC Sec. 6013(a)(3). The executor, for this purpose, includes only an individual who is appointed to such an office and not merely one holding the decedent's property. Treas. Regs. Sec. 1.6013-4.
    - (1) No executor. If no executor is appointed, the surviving spouse can file

a joint return and, unless an appointed executor disavows the filing within one year of the filing date, the return stands as filed. Regs. Sec. 1.6013-1(d)(3).

- (2) Surviving spouse dies too. If the surviving spouse dies before the filing date for the income tax return and all of the surviving spouse's property was in a revocable trust as well, it is possible that no one can file a joint return.
  - (3) There is no legitimate reason why a personal representative cannot be appointed by a probate court absent a probate estate. Where the deceased lived and died out-of-state and left no Virginia estate, an administration that is granted is voidable, but not void. *Andrews v. Avary*, 55 Va. (14 Gratt.) 229 (1858); and *Fisher v. Bassett*, 36 Va. (9 Leigh) 119 (1837). Also, in *Commonwealth v. Hudgin*, 29 Va. (2 Leigh) 248 (1830), the Circuit Court for Henrico County held that it had jurisdiction to grant administration to a nonresident who had no estate in Virginia but who had a claim against the Commonwealth.
- c. QTIP Elections. The decedent's executor is supposed to make the QTIP election. In Ltr. Rul. 8335033 held that the trustee of a funded revocable trust could make this election when there was no personal representative appointed, citing IRC Sec. 2203.
  - d. Series E bonds. The IRS ruled that the executor of the estate of a decedent who had transferred series E savings bonds to a revocable trust could elect (IRC Sec. 454(a)) to report the unreported interest on the decedent's final income tax return. The executor, rather than the trustee, was held to have the authority to make the election because the executor was the one obligated to file the final income tax return, on which

the interest would be reported. Rev. Rul. 79-409, 1979-2 C.B. 208.

6. Alternate valuation date. The estate tax value of a decedent's assets will be their fair market value on the date of death or, if elected, the alternate valuation date. The alternate valuation date is the date six months following the date of death or, if earlier, the date of the distribution of an estate asset. IRC Sec. 2032. Revocable trust distributions within the first six months following the date of death may establish the alternate valuation date for distributed assets.
  - a. "Distribution." The date of distribution of estate assets within the first six months after the date of death is the alternate valuation date.
    - (1) The concept of a distribution, for this purpose, comprehends "all possible ways by which property ceases to form a part of the gross estate." Regs. Sec. 20.2032-1(c)(1).
    - (2) Mere bookkeeping divisions of a revocable trust into subsidiary trusts does not establish the alternate valuation date without an actual distribution to the trusts. Rev. Rul. 71-396, 1971-2 C.B. 328.
    - (3) A trustee's ability to compel distributions within six months after the decedent's death does not alone establish the alternate valuation date. Rev. Rul. 78-431, 1978-2 C.B. 230 (community property was held in a revocable trust and, upon the death of one spouse, divided into two shares: a decedent's share (retained in trust) and a surviving spouse's share which was distributed. Neither the distribution of the surviving spouse's share nor the trustee's ability to compel distribution constituted a distribution for alternate valuation purposes).

- b. Estate distributions. The distribution of estate assets to a revocable trust the corpus of which was includible in the decedent's gross estate should not establish the alternate valuation date, since the assets remain part of the gross estate.
  - c. Trust divisions and distributions. Revocable trusts commonly divide their assets (including those received as a pour-over from the estate) into subsidiary marital and non-marital deduction trusts. The I.R.S. has ruled that a division of the corpus of a revocable trust into two separate shares without termination of the revocable trust does not constitute a distribution establishing the alternate valuation date. Rev. Rul. 57-495, 1957-2 C.B. 616. However, a division of the trust corpus of a revocable trust into separate shares did establish the alternate valuation date when the trust then dropped the assets into subsidiary trusts and terminated. Rev. Rul. 73-97, 1973-1 C.B. 404. The IRS distinguished the two rulings by the fact that the revocable trust had not terminated in the 1957 ruling, but this distinction appears artificial and ill-considered. See discussion in Julian S. Bush, "The Closely Held Business in the Revocable Trust: Advantages and Post-Death Problems," 34th N.Y.U. INST. ON FED. TAX. 1621, 1647-1649 (1976); Stanton D. Rosenbaum, "Unique Applications and Pitfalls of Revocable Trusts," 29th U. SO. CAL. TAX INST. 503, 518 (1977); and Howard M. Zaritsky, "Special Trusts and Unique Problems: Grantor Trusts After the Grantor's Death, Alimony Trusts, and Foreign Trusts versus Domestic Trusts," 37th N.Y.U. INST. ON FED. TAX. ch. 42, at 42-12 to 42-13 (1979).
- 7. Deduction of administration expenses. An income tax deduction or an estate tax deduction, but not both, is allowed for their reasonable expenses of estate administration. IRC Secs. 642(g) and 2053.
  - a. General rule. The administration expenses of a revocable trust, whether funded or unfunded, are deductible against the gross

estate to the extent they are subject to the debts and claims of the estate. Regs. Sec. 20.2053-1(a)(1); and Estate of DeFoucancourt v. Comm'r, 62 T.C. 485 (1974).

b. Exceptions:

- (1) Trust assets not subject to estate claims. If the assets of the revocable trust are not available to satisfy estate claims and expenses, the only deductible trust administration expenses are those engendered by the decedent's death, incurred in vesting good title in the beneficiaries, and paid within three years from the filing of the estate tax return. Regs. Sec. 20.2053-8.
- (2) Excess deductible estate expenses. If the total of the deductible estate administration expenses exceeds the estate subject to claims, other expenses incurred by the trust may be deducted, if paid before the return is filed. Regs. Sec. 20.2053-1(c).

c. Planning. Normally, executors consider only the relative income and estate tax brackets of the estate in determining whether to deduct these costs as income or estate tax expenses. When a revocable trust has been used, however, income-splitting will commonly occur and the estate tax brackets should be compared with the income tax brackets of both the estate and the trust.

8. Special use valuation. Real property used in a farm or other closely-held business may be valued at its present use, rather than at its highest and best use, if certain requirements are met. IRC Sec. 2032A. The election to specially valued real estate may be imperiled if the property is held in a revocable trust.

a. "Acquired from the decedent." The specially valued real property must be acquired from the decedent, as defined for basis purposes. Consequently, acquisition through a revocable trust will not jeopardize the special use

valuation, even if the property is distributed in satisfaction of a pecuniary bequest. IRC Sec. 2032A(e)(9).

- b. Ownership through a trust. The specially valued real property must have been owned by the decedent and must pass to qualified heirs. The legislative history of the Tax Reform Act of 1976 required the Treasury Department to issue regulations explaining how the property is to be treated when it is owned in trust, and these regulations were issued in July, 1980. See Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 at 539 (1976) (Committee Print); and Regs. Sec. 20.2032A-3(b)(1).

- (1) The regulations require that a qualified heir receiving an indirect interest in real property, because the property is owned by a trust, must receive or acquire "a present interest in the property (determined under section 2503) from the decedent." Regs. Sec. 20.2032A-3(b)(1).

- (2) Material participation. The regulations allow material participation of the decedent and the heirs though the property is owned by a trust. However, such participation must be pursuant to an arrangement calling for material participation by the decedent or a family member, in one of four situations:

- (a) The arrangement may result from appointment of the decedent or family member as trustee;

- (b) The arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely-held business owned by the trust in a position requiring material participation in its activities;

- (c) The participants may enter into a contract with the trustee to manage, or take part in managing, the real property for the trust; or
  - (d) The trust agreement may expressly grant the managerial rights to the beneficial owner.
- 9. Extended estate tax payments. Estate taxes are normally due when the return is required to be filed, nine months after the date of death. IRC Secs. 6075(a), 6151. However, IRC Sec. 6166 allows the payment of the estate taxes attributable to an interest in a closely-held business in up to ten equal annual installments, with a five year moratorium on payments. The benefits of IRC Sec. 6166 are available to business interests held in revocable trusts, as well as those passing to the personal representative's control.
- 10. S corporation stock. The shareholders of a small business corporation may elect to have the income of the corporation taxed directly to them, avoiding tax at the corporate level. Special post mortem planning problems arise when subchapter S stock is held by a revocable trust. See Burton W. Kantor, "Use of a Grantor Trust as a Subchapter S Shareholder Made Easier by 1978 Revenue Act," 50 J. TAX'N 194 (April 1979); and Burton W. Kantor, "Planning and Pitfalls on the Disposition of Subchapter S Stock Held by a Grantor Trust," 50 J. TAX'N 284 (May 1979).
  - a. A revocable trust as a shareholder. Prior to the 1976 Tax Reform Act, revocable trusts could not be subchapter S shareholders. See e.g., American Nurseryman Publishing Co. v. Comm'r, 75 T.C. No. 19 (1980) (decided under pre-1976 Act rules, in which the transfer of the stock to the trust was made unintentionally and a state court voided it ab initio, but the corporate election was still involuntarily terminated). The 1976 Act said that a revocable trust (or any other trust "treated as owned by the grantor under subpart E of part I of subchapter J") may be a

subchapter S shareholder. IRC. Sec. 1371(f)(1).

- b. Post mortem problems. After the grantor dies, however, a revocable trust ceases to be described in subpart E of part I of subchapter J, so the 1978 Revenue Act amended the statutory rules to provide that if the entire corpus of the trust was includible in the grantor's gross estate, as with a revocable trust, the subchapter S election is not terminated when the grantor dies. Rather, the trustee may distribute the stock to another eligible shareholder within two years following the date of death. IRC Sec. 1371(e)(1)(B).

c. Planning problems.

- (1) Perhaps the greatest problem is that the revocable trust is not permanently a subchapter S shareholder and corrective action must be taken within only two years. The trust must dispose of the stock and, if the trust agreement contains no express provision for distribution of the stock, the trustee is placed in the rather precarious position of weighing violation of the trust agreement against possibly adverse income tax consequences.
- (2) Even if the trustee can distribute the stock to the trust beneficiaries, the election will be terminated if the beneficiaries are not themselves qualifying shareholders. For example, if the beneficiaries are nonresident aliens, corporations, or other trusts, the corporate election will terminate. Additionally, if the remainder of the trust is to be distributed to more than one beneficiary, the division of the stock may increase the number of shareholders above the permissible 35.

- 11. Buy-sell agreements with revocable trusts. If closely-held stock is held in a revocable trust, caution should be exercised in the entering into

of buy-sell agreements. If the trust is subsequently revoked, the agreement may be voided and the valuation established in the agreement will cease to be binding for estate tax purposes. See *Anderson v. Comm'r*, 619 F. 2d 587 (6th Cir. 1980), aff'g, T.C. Memo para. 77,237 (1977).

12. Discharge of the executor's liability. Both the executor of the estate and the trustee of the revocable trust are liable for the estate taxes attaching to the property under their control, to the extent it was includible in the grantor's gross estate. IRC Sec. 6324(a)(2).
  - a. Request for discharge. The executor can file a request for discharge of personal liability for any deficiency. IRC Sec. 2204. The trustee of a revocable trust cannot take advantage of this discharge request. Rev. Rul. 57-424, 1957-2 C.B. 523 (in which there were both an executor and a trustee). If the same person is both trustee and executor, it is not clear whether any discharge can be effectuated.
  - b. Transferee liability. Transferee liability applies only to the liability relating to assets of the grantor's estate under IRC Secs. 2034 through 2042, and not to those included under IRC Sec. 2033. Therefore, if a funded revocable trust pours-back to the estate upon the decedent's death, the trustee is not subject to transferee liability with regard to these properties. Rev. Rul. 75-553, 1975-2 C.B. 477.
13. Disclaimers. An individual may, without estate or gift tax consequences, disclaim an interest passing to the individual by gift or bequest. The disclaimer must be unequivocal, valid, and must be made within nine months after the transfer of the property to the disclaimant. IRC Sec. 2518. The IRS has ruled privately that a disclaimer of an interest in a revocable trust funded by a pour-over from the grantor's will must be made within nine months from the date of death, when the trust is funded, since before that time the disclaimant has no disclaimable interest. Ltr. Rul. 8003020.

14. Generation-Skipping Transfer Tax Problems. The \$1 million exemption for generation-skipping transfers may be allocated by "the transfer (or his executor)." IRC Sec. 2631(a)(1). Furthermore, where a marital deduction is allowed for qualifying terminable interest property in trust, "the estate of the decedent or the donor spouse" may elect to treat the property as if no such election had been made. IRC Sec. 2652(a)(3). In both cases, what if there is no personal representative because the entire estate is contained in a funded revocable trust?
- a. IRC Sec. 2203, which says that when there is no personal representative appointed under state law, the person in custody of property is the "executor" for purpose of estate tax elections and filing the estate tax return. There is no comparable provision in Chapter 13.
  - b. Is a pour-back of the trust funds to the estate required to permit this election?