5-28-1993

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HOW MANY LIVING TRUSTS?

— by Neil E. Harl*

The popularity of revocable living trusts has convinced many couples that it’s a good idea. But planners have had differing views on whether a husband and wife should have one joint living trust or each should have their own.¹

- In community property states, a major reason for joint trusts is that assets can retain their character as community property if the trust establishes that — (1) the grantors intend that the trust property will continue to be community property, (2) all income from the assets will be community property and (3) if assets are withdrawn from the trust, community property status is retained.² This is important in that community property receives a 100 percent step up (or step down) in income tax basis at the death of the first spouse to die.³ This is a compelling reason to use a joint trust in community property states.

- The arguments for separate trusts generally point out that, if each has their own, that spouse can revoke their own trust even though the other spouse dies or becomes incapacitated. And each can revoke their own trust if they simply cannot agree on what to do.

These are persuasive arguments for dividing the property and creating two trusts, usually with mirror-image provisions at death. Creating balanced estates represents sound planning — any time the combined family wealth exceeds $600,000 — if one of the objectives is to minimize the death taxes over both deaths. Or if the objective is to pass a maximum amount of wealth from the estate of the survivor.

- Those urging a single joint trust for the spouses may have another objective in mind — obtaining a new income tax basis for all of the property at both deaths.⁴

With separate trusts, at the death of the first spouse to die, the property in that spouse's trust is subject to federal estate tax — and gets a new income tax basis.⁵ The result is that potential gains on the property (as well as potential losses) are wiped out. And because of the 100 percent federal estate tax marital deduction,⁶ there's no federal estate tax due if the property passes to the survivor outright.

By using a joint trust, and giving each spouse a general power of appointment over the entire trust, the entire value of the property is included in the estate of the first to die and the entire amount of property receives a new income tax basis at that person's death. A general power of appointment means that the power could be exercised to benefit the person holding the power.⁷

One problem with that approach has been that, without careful planning, it may run up the tax bill at the survivor's death to leave all of the family wealth to the survivor outright. For those with estates over $600,000, some federal estate tax would be due at the second death if everything is left to the survivor.

Now the Internal Revenue Service has supplied another reason to be cautious about joint revocable living trusts. IRS ruled recently that only one-half of the property received a new income tax basis at the death of the first to die, not all of it as planned.⁸ In the facts of that ruling, the major part of the property transferred to the trust was property held by the spouses in joint tenancy.⁹ A small part of the property consisted of the spouse's separate property. The net income from the joint trust was to be distributed to the spouses. The trustee had discretion to distribute principal from the trust. During their joint lives, either spouse acting alone could revoke the trust. In that event, an undivided one-half interest in the property of the trust would be distributed to each spouse. Each of them had a general power of appointment over all of the property exercisable at death.¹⁰ If the power was not exercised, the entire amount of trust property passed to the surviving spouse at the first death.

The wife died about a month after the trust was created with the power left unexercised.¹¹ The trust property passed to the husband. The entire amount of property was subject to federal estate tax, but only one-half received a new income tax basis.¹²

The reasoning behind the ruling is that the surviving spouse held dominion and control over the property throughout the year prior to the decedent's death since the trust could be revoked at any time.¹³ Because the surviving spouse never relinquished dominion and control over the property, and the property reverted back to the donor at the death of the first spouse to die, the transaction comes within the special rule that disallows a new basis at death.¹⁴ Under that provision, if appreciated property is acquired by the

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The next issue will be published June 25, 1993.
decendent by gift during the one-year period ending on the date of the decedent's death, and the property passes from the decedent back to the donor of the property, the basis of the property remains the adjusted basis in the hands of the decedent immediately prior to death.\(^1\) Thus, a new basis is denied to the property.

Although the ruling has been criticized, it dampens the enthusiasm for joint living trusts for spouses.

**FOOTNOTES**


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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**BANKRUPTCY**

**GENERAL**

**ESTATE PROPERTY-ALM § 13.03[4].** The debtor had received a life estate in a farm by testamentary bequest from the debtor's parent. The debtor mortgaged the farm and after defaulting on the secured loan, entered into a settlement with the lender for $80,000 which was placed in a spendthrift trust for the debtor. A bankruptcy creditor challenged the trust as fraudulent because a settlor cannot be a beneficiary of a spendthrift trust. The debtor argued that the trust was established by either the lender or the court and was valid. The court held that the trust was established by the debtor as part of the default settlement and included the trust property in the bankruptcy estate. *In re Morris, 151 B.R. 900 (C.D. Ill. 1993)*, aff'g, 144 B.R. 401 (Bankr. C.D. Ill. 1992).

**EXEMPTIONS-ALM § 13.03[4]**

**ANNUITY.** The debtor owned several annuities which were claimed as exempt under Iowa Code § 627.6(8)(e). The court held that because the debtor had the right to withdraw amounts from the annuities at any time, the annuities were not eligible for the exemption. *In re Huehner, 986 F.2d 1222 (8th Cir. 1993)*, aff'g, 141 B.R. 405 (N.D. Iowa 1992).

**AVOIDABLE LIENS.** The debtor had granted three mortgages against the debtor’s residence which in total exceeded the fair market value of the residence. Prior to the granting of the third mortgage, a creditor had perfected a judgment lien against the residence, and the debtor sought to avoid this lien as impairing the homestead exemption. The court held that the lien could not be avoided because the avoidance would elevate the third mortgage in priority, an action not authorized by the Bankruptcy Code. Thus, a debtor can only avoid liens in reverse priority order and later consensual liens will insulate prior avoidable liens from avoidance. *In re Thomson McKinnon, Inc., 151 B.R. 324 (S.D. N.Y. 1993).*

**AVOIDABLE TRANSFERS.** Less than three months before filing for bankruptcy, the debtor transferred a residence to the debtor and nondebtor spouse as tenants by the entirety. The debtor claimed the residence as exempt. After the period for objecting to exemptions had passed, the trustee sought to avoid the pre-bankruptcy transfer of the residence as a fraudulent conveyance. The debtor argued that the objection was untimely because the successful avoidance of the transfer would make the residence ineligible for the exemption and the period for challenging exemptions had expired. The court held that the limitation period for objecting to exemptions did not govern the right of the trustee to seek avoidance of pre-bankruptcy transfers. *In re Harry, 151 B.R. 735 (Bankr. W.D. Va. 1992).*

**HOMESTEAD.** The debtors were husband and wife and each claimed a full $5,000 exemption for the homestead. The trustee objected to the wife’s exemption, arguing that the wife had no interest in the homestead because title to the property was solely in the husband’s name. The court held that the wife could claim an exemption up to the present value of the wife’s dower interest in the homestead. *In re Miller, 151 B.R. 800 (Bankr. N.D. Ohio 1992).*

The debtor and nondebtor spouse owned a residence as tenants by the entirety. The trustee claimed the residence as exempt. After the period for objecting to exemptions had passed, the trustee sought to avoid the pre-bankruptcy transfer of the residence as a fraudulent conveyance. The debtor argued that the objection was untimely because the successful avoidance of the transfer would make the residence ineligible for the exemption and the period for challenging exemptions had expired. The court held that the limitation period for objecting to exemptions did not govern the right of the trustee to seek avoidance of pre-bankruptcy transfers. *In re Harry, 151 B.R. 735 (Bankr. W.D. Va. 1992).*

**ATTORNEY’S FEES.** The Chapter 12 debtor had substantially completed all plan payments and had filed a Final Report and Account in preparation for requesting a

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*For information about ordering the Manual, see the last page of this issue.*