<u>REVOCABLE INTER VIVOS TRUSTS</u>

By Fred Franke

I. General Considerations.

A. What Constitutes a "Trust"?

a. An express trust is one that comes into being when a person having the power to create a trust expresses an intent to have a trust arise and take steps to create a trust.

"To constitute an express trust, various combinations of elements have been said to be essential, the most common one being: Sufficient words to create it; a definite subject, and a certain and ascertained object. It would seem, however, that the elements of an express trust, as distinguished from the acts or words necessary to create it, are the same as those of all trusts, and consist of a trust res or subject matter, <u>and the holding of the legal title of that property by one person for the benefit of another</u>, while the matters requisite to create such a trust as a sufficient declaration of trust, evidencing an intention to create a trust and setting out the trust property, terms, and parties with reasonable certainty, and a transfer of the legal title by the owner of the property to a trustee to be held for the benefit of another, or a retention of title by the owner under circumstances which clearly and unequivocally disclose an intent to hold for the use of another." <u>*Sieling v. Sieling*</u>, 151 Md. 536, 549-550 (1926) (quoting, "39 Cyc. 34"). (Emphasis added.)

b. Whether an express trust has been created is a factual determination. In <u>*In Re Shank*</u>, 240 B.R. 216 (Bkrtcy. D. Md. 1999) (Judge Derby), debtors under a Chapter 11 plan sought to characterize a reorganization plan which formed an asset pool for the benefit of certain secured creditors as a "trust" so that the tax liability generated from the sale of those assets would be netted against the assets in the pool rather than pass through to the debtors. Under a bankruptcy reorganization, the debtors retained legal title to the asset pool assets subject, however, to various claims running in favor of creditors. The debtors made two alternative arguments; (i) that the creation of the asset pool coupled with the extensive powers over that pool granted to a creditor representative created a trust with the creditor representative as trustee; or (ii) that the debtor in possession retained ownership of the property but that the property was being held for the benefit of the creditors. As to the first contention, Judge Derby found that extensive powers held by someone over property without the holding of legal title does not make that person a trustee:

> "Debtors argue that the creditors' Representative's wide ranging power over the Asset Pool assets requires that court to find that a trust was created with the Creditors' Representative as its trustee. This is a fallacious argument, akin to arguing that because all dogs have four legs, all four-legged entities must be dogs. The fact that the Creditors' Representative had extensive obligations under the Plan is also consistent with the proposition that the Creditor's Representative was the collection agent of the unsecured claim holders, charged with the task of collecting the debt that the Plan created. As stated above, the existence of a trustee is derivative from the finding that there has been a proper declaration of trust. See <u>*Sieling*</u>, 135 A. at 380. While the Creditors' Representative may have had some of

the characteristics of a trustee, he certainly lacked the most prominent: that of holding legal title to the property." (*Shank* at 223.)

Judge Derby also dismissed the debtors' alternative argument: that the debtor was a trustee for the creditor by holding that the debtors' "duties under the plan were perfunctory and colorless – akin to the contractual obligations incident to a contract to convey residential rental property … A contract to convey property is not a trust. See Restatement (2nd) of Trust § 13." (*Shank* at 223.) Implicit in *In Re Shank* is the issue that a separation of the equitable from the legal estate must exist in order for a trust to exist.

c. It has been held that "a person cannot be both the trustee and the cestui que trust. In order to create a trust the legal estate must be separated from the beneficial enjoyment. A trust cannot exist where the same person possesses both." *Gray v. Harriet Lane Home for Invalid Children*. 192 Md. 251, 264 (1949). In *Gray v. Harriet Lane Home for Invalid Children*, the Court found that a trust was not created, in part, because of the lack of a beneficiary separate from the trustee. That case involved a bequest to a charity before the adoption of the doctrine of "cy pres" in Maryland. The will left substantial property to the Harriet Lane Home the income of which was to be used to operate contagious disease wards. The testatrix was definite as to the type of contagious disease units to be run and that a substantial amount of the bed space should be available to poor children. The particular contagious diseases that were the target of the testatrix's charitable intent (scarlet fever and diphtheria) were removed as a menace because of immunization and available drug therapy. Additionally, open wards were, at the time of the testatrix's death, considered unacceptable for the care of patients with contagious diseases. The legal heirs of the testatrix claimed that the bequest was for specific purposes, and that because those purposes could not be accomplished, the remaindermen, presumably, would receive the property. The Court held that no trust could exist because the gift was to the Harriet Lane Home and it would, in effect, be trustee for itself. The Court also held that the bequest was either absolute (creating an endowment fund for the home) or not an absolute gift but an estate on a condition subsequent. The Court held that conditions subsequent are not favored by the law because the breach of such a condition causes a forfeiture and the law is adverse to forfeitures. Indeed, it held that the "conditions" were merely expressing the grantor's confidence that the grantee would use the property as closely as practicable for the effect specified. Today, of course, the cy pres statute would remedy this situation. Additionally, the institutional charitable funds statute would alter the "income only" character of the endowment.

d. The rule that a trust cannot exist without a separation of the legal and equitable title raises an issue as to the efficacy of revocable trusts used as Will substitutes. In the basic revocable trust the settlor is the sole trustee during his or her competency. In addition, the settlor retains the right to amend or revoke the trust. Maryland has no case directly upholding this standard arrangement. There are cases, however, where the Court discusses revocable trusts without raising the issue as to such arrangements being illusory. In *Upman v. Clarke*, 359 Md. 32 (2000) the Court noted but did not otherwise discuss that the property was placed in trust initially with the settlor as sole trustee. Other jurisdictions have held that the revocable trust is valid as a trust because it has another beneficiary at the death of the settlor. Due to the revocable nature of the trust, however, this beneficiary has a very tenuous hold on the trust. See Restatement of Law of Trusts (2nd) § 56 Comments f; *Farkas v. Williams*, 125 N.E. 2nd, 600 (Ill., 1955) ("A contingent equitable interest in remainder.") The Maryland Courts addressed an analogous situation in an irrevocable in trust in *U.S. v. Baldwin*, 283 Md. 586 (1978). In that case the settlor retained a life estate in the assets, the right to name himself as trustee, and a limited testamentary power of appointment so that he could name any person as the remaindermen. In *Baldwin*, the Court held that the remaindermen had "vested remainder in the trust corpus, subject to divestment by Baldwin's exercise of his testamentary power." *Baldwin* at 595. This created a beneficiary separate and apart from the settlor. See also *Pope v. Safe Dep. & Tr. Co.*, 163 Md. 239 (1932). Presumably, the Court of Appeals would uphold the basic revocable trust arrangement if it is presented to it. It cannot be denied, however, that there is a fundamental tension between the basic principles underlying a law of trust and the recognition of a revocable trust as a "trust." A trust is characterized by the bundle of fiduciary obligations that the trustee owes to the beneficiary.

e. Maryland holds that only when there is a total identity between beneficial and equitable titles does merger apply:

"It is true that, if the settlor reserves the right to use the property, and does use it in accordance with the terms of the trust, as evidenced from the intention of the parties, there may be nothing remaining at the death of the settlor; but the question of whether or not a trust has been created cannot be made to depend upon whether there may or may not be property existing at the time the beneficiaries are entitled to the enjoyment thereof. In the case *Milholland v. Whalen*, supra., this Court held that there was a valid subsisting trust created from the time Miss O'Neill made the deposit in the bank in the form in which it was made, and that without regard to the fact that she retained possession of the passbook by which she might have withdrawn all the funds, which were subject of the trust, before her death. It will be seen in that case that the settlor retained at least as complete control and dominion over the subject of the trust as is contained in the instrument of writing in this case made by Johann Sieling and Anna Sieling; the effect in that case being that if there was any money remaining in the bank which was the subject of trust at the death of settlor, it should go, by virtue of the declaration of trust, to her sister." *Sieling* at 548, 549."

f. If there is no separation between the identity of the trustee and the beneficiary, then there would be no one to enforce the fiduciary obligations. The Court of Special Appeals had adopted this essential aspect of a trust in *Jacob v. Davis*, 128 Md. App. 433 (1999) when it quotes the observation in *Bogert on Trusts* that there must be an obligation to account:

> "A [testator] who attempts to create a trust without any accountability in the trustee is contradicting himself. A trust necessarily grants rights to a beneficiary that are enforceable in equity. If the trustee cannot be called to account, the beneficiary cannot force the trustee to any particular line of conduct with regard to the trust property or sue for breach of trust. The trustee may do as he likes with the property, and the beneficiary is without remedy. If the court finds that the settlor really intended a trust, it would seem that accountability in chancery or other court must inevitably follow as an incident. Without an account the beneficiary must be in the dark as to whether there has been a breach of trust and so is prevented as a practical manner from holding the trustee liable for a breach." (Quoting *Bogert* at 450.)

The Uniform Trust Code (2003) provides that a trust is created only if "the same person is not sole trustee and sole beneficiary." UTC § 402(a)(5). UTC Comment on this section states: "Subsection (a)(5) addresses the doctrine of merger, which, as traditionally stated, provides that a trust is not created if the settlor is the sole trustee and sole beneficiary of *all* beneficial interests. The doctrine of merger has been inappropriately applied by the courts in some jurisdictions to invalidate self-declarations of trust in which the settlor is the sole life beneficiary but other person are designated as beneficiaries of the remainder. The doctrine of merger is properly applicable only if all beneficiary interest both life interest and remainders, are vested in the same person, whether in the settlor or someone else. An example of a trust to which the doctrine of merger would apply is a trust of which the settlor is sole trustee, sole beneficiary for life, and with the remainder payable to the settlor's probate estate. On the doctrine of merger generally, see Restatement (Third) of Trust Section 69 (Tentative Draft No. 3, 2001); Restatement (Second) of Trust Section 341 (1959).

Thus, under the UTC a revocable trust with the settlor the sole trustee and sole lifetime beneficiary will be recognized as a valid trust if remaindermen are named. The *Davis* issue is solved by UTC § 603 which states that while a trust is revocable and the settlor has the capacity to revoke, the remaindermen cannot enforce their rights and the duty of the trustee to provide information is solely to the settlor.

B. Revocable Trust.

a. A revocable trust is an inter vivos trust whereby the grantor retains the power to revoke the trust and reacquire the trust property.

b. At the grantor's death, the trust becomes irrevocable. At death, the trust may continue with a direction that distributions are made to named beneficiaries (or to a class of beneficiaries) or terminate.

(1) Under the Common Law of Maryland (and elsewhere), a trust that is silent as to revocability is presumed irrevocable. *Liberty Trust Co. v. Weber*, 200 Md. 491 (1952).

The Uniform Trust Code (2003) adopts a default rule that reverses the Common Law and assumes revocability. It also provides that a revocable trust may be revoked or amended by the settlor. If the trust is created or funded by more than one settlor, "each settlor may revoke or amend the trust with regard to the portion of the trust property attributable to the settlor's contribution." UTC § 602 (a) and (b). As noted, the UTC adopts the minority approach when it makes trusts presumptively revocable. Currently, California, Iowa, Montana, Oklahoma and Texas presume revocability. See UTC Comment at § 602.

(2) An irrevocable trust agreement may be set aside on grounds that contracts may be set aside: fraud, duress, undue influence, breach of a confidential relationship, or mistake. There is no presumption of mistake. Mistake must be shown by affirmative evidence that the grantor believed that he or she had the power to revoke. The mere fact that the grantor believed ~~t~~that he or she could revoke the trust is not a sufficient ground for reforming the instrument. *Liberty*

Trust Company v. Weber, 200 Md. 491 (1952). See also footnote 11 in Shriners Hospitals v. Md. Nat'l Bk., 270 Md. 564 (1973):

> "Some cases may warrant the cancellation of inter vivos trusts on the ground of mistake or misunderstanding, see *Atkinson v. Atkinson*, 157 Md. 648, 147 A. 662 (129) (settlor, aged and infirm, misunderstood meaning of trust of deed); *Raffel v. Safe Deposit & Trust Co.*, 100 Md. 141, 59 A. 702 (1905) (inexperienced settlor under mistaken belief regarding her power to *revoke trust* deed). Compare other cases where such relief was denied, e.g., *Lambdin v. Datzebecker*, 169 Md. 240, 181 A. 353 (1935); *Peter v. Peter*, 136 Md. 157, 110 A. 211 (1920) (settlor was an attorney); *Kensett v. Safe Deposit & Trust Co.*, 116 Md. 526, 82 A. 981 (1911); *Dayton v. Stewart*, 99 Md. 643, 59 A. 281 (1904); *Brown v. Mercantile Trust & Deposit Co.*, 87 Md. 377, 40 A. 256 (1898)."

(3) The doctrine that a trust instrument may be reformed by a court to correct a mistake "is ordinarily applicable only in cases … involving inter vivos trust instruments." Testamentary trusts are treated as wills and "the general prohibition against the reformation of a will would prevail" in cases seeking reformation of a testamentary trust. *Shriners Hospitals v. Md. Nat'l Bk.*, 270 Md. 564, 581-2 (1973). See, however, *Probasco v. Clark*, 58 Md. App. 683, 687 (1984) (involving a testamentary trust): "Courts do, however, have the inherent power to modify a trust so long as that authority is exercised with caution and not employed merely as a tool or devise to enable beneficiaries to receive [an increased amount.]" Also see In Re Trust of Lane, 323 Md. 188 (1991), where the Court permitted a modification of a trust where the remaindermen agreed to the modification. There was no spendthrift clause in *Lane*. A spendthrift clause would have precluded change.

(4) Apparently, if a trust that is "irrevocable" by its terms is later reformed by a court to become revocable, the federal tax law may permit an amended gift tax return to reflect that there was no completed gift in the first instance. In Berger v. U.S., 487 F. Supp. 49 (W.D. Pa., 1980), C. William Berger anticipated a high level job with the Nixon administration at the FAA. He mistakenly believed that he had to place all of his assets into an irrevocable trust in order to comply with the Nixon administration's policy on conflict of interest. Apparently a revocable trust would have been sufficient. After his prospects of government service evaporated, he successfully argued in the state court that the "irrevocable" aspect of the trust was a mistake and the trust was reformed.

c. Revocable trusts of course, are revocable by the grantor.

(1) The revocation (or amendment) of a trust is not governed by statute but governed by the terms of the trust document. *Estates and Trusts Article* § 4-105 provides that wills are revoked by (i) a subsequent will, (ii) destruction by "burning, canceling, tearing, or obliterating" same, (iii) by the subsequent marriage of the testator followed by the birth, adoption or legitimation of a children, or (iv) divorce or annulment which revokes those provisions related to the ex-spouse. No state statute exists to cover the revocation of revocable trusts. See *Estates and Trusts Article* § 14-102 which bootstraps various definitional terms pertaining to wills to cover revocable trusts. Although one such definition is "spouse," the revocation provisions of *Estates and*

Trusts § 4-105 is not bootstrapped. Although no Maryland case has been reported on point, see *Paine Webber v. East*, 363 Md. 408 (2001) (pre-divorce IRA designation to ex-spouse survives divorce despite an incorporated separation agreement that, apparently imperfectly, addressed interests in retirement funds) and see *Cassiday v. Cassiday*, 256 Md. 5 (1969) (pre-divorce insurance beneficiary designation to ex-spouse survives divorce decree).

The Uniform Trust Code (2003) provides that a settlor may revoke a revocable trust by "substantial compliance" with the method provided by the trust, or "if the terms of the trust do not provide a method or the method provided in the terms is not expressly made exclusive" by (i) a later will or codicil that expressly refers to the trust or "specifically devises property that would otherwise have passed accordingly to the terms of the trust, or (ii) by "any other method manifesting clear and convincing evidence of the settlor's intent to revoke the trust. While revocation of a trust will ordinarily continue to be accomplished by signing and delivering a written document to the trustee, other methods, such as a physical act or oral statement coupled with a withdrawal of property, might also demonstrate the necessary intent. These less formal methods, because they provide less reliable indicia of intent, will often be insufficient, however. The method specified in the terms of the trust is a reliable safe harbor and should be followed whenever possible." UTC Comment at § 602.

(2) Under the Maryland guardianship provisions, "a guardian may exercise any inter vivos power which the … disabled person could have exercised under an instrument." *Estates and Trusts* § 13-213 and § 15-102(x). Presumably, therefore, a guardian could revoke a revocable trust. Prudence would suggest that the guardian seek court authority.

The Uniform Trust Code (2003) permits the settlor's guardian to revoke or amend the trust only with court approval. UTC Comment at 602: "Because a settlor often creates a revocable trust for the very purpose of avoiding conservatorship, this power should be exercised by the court reluctantly. Settlors concerned about revocation by a conservator may wish to deny a conservator a power to revoke. However, while such a provision in the terms of the trust is entitled to considerable weight, the court may override the restriction if it concludes that the action is necessary in the interest of justice."

(3) In *Ullman v. Garcia*, 645 So. 2d 168 (Fla. 1994), a guardian could not contest the terms of a revocable trust on the basis of undue influence until the death of the grantor: "Undue influence is not an available remedy because the unique nature of a revocable trust is that it reserves to the settlor the power to end the trust at any time, and postpones the devisee's enjoyment of the trust until the settlor's death." In other words, the testamentary provisions come into being, and can be challenged, upon the death of the grantor but not before.

C. Joint Trusts.

1. Definition.

a. A joint rust is an express trust formed by two (or more) grantors. Generally, this refers to a revocable trust created by a husband and a wife as grantors.

2. Revocation of Joint Trusts.

Under current Maryland law, one must look to the trust instrument to ascertain whether it is revocable because Maryland follows the Common Law rule that trusts are, by default, irrevocable. Thus, the fact of revocability and its extent are governed by the trust instrument, not statute or case law.

The Uniform Trust Code provides that each settlor of a joint trust may revoke or amend the trust with regard to portions of the trust property attributable to that settlor's contribution. A special rule applies when community property rights are concerned. UTC § 602(b). The Comment states: "Subsection (b) does not address the many technical issues that can arise in determine the settlors' proportionate contribution to a joint trust … In the case of joint tenancies of real estate, each spouse would presumably be treated as having made an equal contribution because of the right to sever the interest and convert it into a tenancy in common … Most difficult may be determining a contribution rule for entireties property. In *Holdener v. Fieser*, 971 S.W. 2d 946 (Mo. Ct. App. 1998), the court held that a surviving spouse could revoke the trust with respect to the entire interest but did not express a view as to revocation while both spouses were living." [Missouri has adopted 602 of the UTC. Its effect on entireties property contributed to a joint trust is uncertain: "Because this article addresses issues only if raised by the new statutes, a long-standing concern about entireties property transferred to a trust will be noted only in passing. Tenancy by the entireties property is exempt from the creditors of just one spouse. Unfortunately, it is not clear that entireties property will retain this characterization, and, hence, protection from creditors, once it is transferred to a trust (because it is then held by the trustees, not by the spouses in their individual capacities). Consequently, planners should consider retaining entireties property outside the trust and using a non-probate transfer to the trust upon the death of one or both spouses." Riley, "New Drafting Issues for Revocable Trusts," 62 J. Mo. B. 22 (Jan/Feb 2006), at note 5.

3. Joint Trusts and Entireties Property.

Maryland retains the traditional form of tenancy by the entireties. *Columbia Carbon Co. v. Knight*, 207 Md. 203 (1955). It is available only to a married couple holding property. A transfer to a trustee, even spouses as joint trustees of a joint trust, would appear to violate one of the basic elements required for entireties property. Virginia has extended by statute entireties protection to joint trusts in certain instances. A similar approach is under study in Maryland.

4. Joint Trusts/Joint Wills Issues.

Presumably the issues that have dogged joint Wills will likewise be present with joint trusts. ["'[A]s a general rule, joint Wills are not regarded with much favor by the courts, and are … apt to invite litigation.'" Thompson, The Law of Wills, § 34 at 69 (3d ed. 1947) as quoted in *Shimp v. Huff*, 315 Md. 624, 626 (1989).

Joint Wills may create binding obligations not to change the ultimate disposition of property after the first death. Indeed, *Shimp* involved the issue of whether the next spouse's elective share rights trump those contractual obligations. *Shimp* held that public policy considerations require that the contractual rights to be subordinate to the elective share rights. As noted elsewhere, *Knell v. Price*, 318 Md. 501 (1990) may extend the elective share to trusts.

Nevertheless, it is important when drafting a joint trust to spell out whether, and to what degree, the surviving spouse may change the instrument.

D. Funded Revocable Trusts.

a. Funded revocable trusts are popularly referred to as "living trusts."

(1) Funded trusts are used to circumvent probate: "O's will might be described as a document executed by him during his lifetime that will control the devolution of some or all of his property from and after his death, but that is subject to change and revocation by him as long as he lives. Such a description, however, if set forth in any one of several revocable inter vivos property arrangements that are now widely recognized as non-testamentary in character, can be carried out without subjecting the property involved to probate administration on O's death.

The revocable inter vivos trust is one of the widely employed vehicles in the avoidance of probate. Attacks on this type of trust, as being testamentary insofar as the trust provides for the disposition of property from and after death of the settlor, have been made from time to time, but with little success." Casner, "Estate Planning – Avoidance of Probate," 60 *Columbia Law Review* 108, 108-9 (1960).

(2) Maryland appears to follow the general rule that revocable trusts are not testamentary and therefore do not need to follow the execution requirements imposed by *Estates & Trusts Article* § 4-102. See Howard v. Hobbs, 125 Md. 636 (1915) (self-forgiving mortgage not testamentary) and Brown v. Fidelity Trust, 126 Md. 175 (1915) (Transfer to revocable trust is a completed transfer.) See, however, the discussion above related to the necessity of a separation of legal and equitable title.

E. Standby Trusts.

a. Unfunded trusts are referred to as "standby trusts."

(1) "As its name implies, it normally remains unfunded until a triggering event, such as disability, activates it. If the triggering event does not occur, the standby trust generally is never funded and simply stands by until the settlor's death." Cantwell and Rhodes, "Standby Trusts: Spare Tires for Late-Life Trips," 19 *The Colorado Lawyer*, 851 (May 1990).

(2) Please note that "unfunded" may be a misnomer because at Common Law, "A trust cannot be created unless there is trust property." Restatement of Trust (Second). By statute, a legacy may be made to an inter vivos trust as long as "the trust instrument has been executed and is in existence prior to or contemporaneously with the execution of the will." Sec. 4-411, *Estates and Trusts Article*, Annotated Code of Maryland; Trosch v. Md. Nat'l Bank, 32 Md. App. 249, 359 A. 2d 564 (1976). The statute, however, only applies to the validity of unfunded

trusts for the purpose of receiving a legacy and may, in fact, simply be reciting the rule concerning incorporation by reference. The general Common Law rules may apply to other circumstances.

The Uniform Trust Code (2003) generally provides that a trust is not in being until funded. UTC § 401. A standby trust is valid, however, as the funding need not be contemporaneous with the signing of the trust instrument. The trust actually comes into being at funding (at death or disability).

b. Another devise for disability planning is the durable power of attorney. Sec. 13-601, et seq. *Estates and Trusts Article*, Annotated Code of Maryland. Durable powers of attorney, however, have certain shortcomings. For a discussion of the differences between trusts and durable powers of attorney, see McGovern, "Trusts, Custodianships, and Durable Powers of Attorney," 27 *Real Property, Probate and Trust Journal*, 1, 23-45 (1992). Some of the more notable differences are as follows:

(1) No clear delineation of the extent of the power of the agent: "The most serous problem with durable powers is the uncertainty as to the agent's powers … [M]ost statutes authorizing durable powers confer no power on the agent. Instead, the statues simply state that powers possessed by the agent are not lost when the principal becomes incapacitated. Therefore, to determine the scope of the agents authority, one must look to the terms of the power and to the law of agency." (Id. At 32.) This, of course, is the approach taken by the Maryland statute.

In Maryland, one of the few reported cases on powers of attorney stands for the proposition that instruments granting a power of attorney are to be strictly construed. King v. Bankerd, 303 Md. 98, 105 (1985): "[O]ne 'well settled' rule is that powers of attorney are 'strictly construed' as a general rule and (are) held to grant only those powers which are clearly delineated … (Although) the rule of strict construction 'cannot override the general and cardinal rule' that the court determines the intention of the parties." In any event, there is a dearth of Maryland authority that deals with powers of attorney which adds ambiguity on the extent of an agent's authority.

The *Second Restatement of Agency* uses the following example to illustrate the narrow construction to be given an agent's powers: "P, a farmer, before going to Europe, gives to A, a general power of attorney, stating that A has authority to manage all of P's business affairs 'as fully as P himself if personally present.' During P's absence, A sells several of P's fields. A is not authorized to sell the fields."

Although we may pride ourselves on being able to draft documents that include sufficient specific power to the agent, very practical problems may arise when the agent attempts to exercise a specific power. "Indeed, it has become so difficult to get financial institutions to accept powers-of-attorney even for routine transactions that legislation has had to be introduced to compel financial institutions to accept even statutory forms of powers-of-attorney." Blattmachr, "The Master Living Trust," 23 *Heckerling Institute On Estate Planning*, 18-16 (1989).

By contrast, the powers of a trustee are more certain with guidance by statute (Titles 14 & 15, *Estates and Trusts Article,* Annotated Code of Maryland) and abundant case law.

(2) Another related uncertainty with a power of attorney involves control. "Agents must carry out the orders of the principal even when the orders are contrary to the terms of the power. Trustees, in contrast, normally are not subject to the control of the settlor or the beneficiaries ... Because a traditional agency terminated when the principal became incompetent, the problem of principal incompetence never arose under the common law. When a principal becomes incompetent, the purpose of the durable power of attorney would be defeated if the attorney had to follow the principal's instructions. Presumably, courts will create an exception to the general rules of agency to cover such situations. On the other hand, agents under a durable power should obey the principal as long as the principal is competent. Situations will arise when an agent is uncertain whether to follow the directions of a possibly incompetent principal, and the agent will seek a court determination of incompetency. Such resort to the courts will defeat one of the primary reasons for using a durable power. " McGovern, supra. at 23-24.

c. A practitioner need not choose sides in the debate of whether to use a durable power of attorney or a trust when engaged in planning for a client's possible disability. Indeed, generally a standby trust is considered in conjunction with a durable power of attorney that is used to fund the trust if that eventuality becomes necessary.

F. The Marketing of Living Trusts.

1. Living Trusts are Heavily Marketed.

a. Living trusts are "being hyped these days on television, in do-it-yourself kits and at coffee-and-doughnuts seminars." Roha, "Living Trusts: Beyond the Hype," *Kiplinger's Persona Finance Magazine* (October 1991).

(1) Unfortunately, a popular impression is fostered by this marketing that funded revocable trusts are "cure-alls," appropriate for every situation. "[W]hen hurled like some all purpose placebo at every estate plan that comes through the door, it is only by fortunate coincidence that revocable trusts produce the desired advantages." Jones, "Putting Revocable Trusts in Their Place," 129 *Trusts & Estates,* 8 (September 1990).

(2) "The sale of a trust package, where the insertion of a product precedes the identification of the problem(s), is the antithesis of good planning, a process which starts with an investigation of your problems and goals and ends with the implementation of one or more appropriate tools or techniques." Leimberg, <u>The New Book of Trusts</u>, Archive Message 60, Leimbergservices.com (8/20/99).

b. Clients are bombarded with emotional, and misleading, information. For example: "Probate … is essentially a form of private taxation levied by the legal profession upon the rest of the population." Dacey, *How to Avoid Probate!* (Crown, 1983).

c. Indeed, in some cases, the public marketing (including door-to-door sales efforts!) has resulted in action by a number of attorneys general in several jurisdictions. Stiegal, Norrgard & Talbert, "Scams in the marketing and Sale of Living Trusts: A New Fraud for the 1990's, " 26 *Clearinghouse Review*, 609 (October 1992): "Many older people are unfamiliar with or fearful about probate and guardianship; the marketing and sale of living trusts to these people is an area ripe for fraud and abuse." (Id. At 609).

d. Aggressive "trust mills" have foisted unnecessary and costly documents on elderly individuals, using fear and greed as leverage. Efforts at regulating "trust mills" have proved elusive. Vallario, <u>Living Trusts in the Unauthorized Practice of Law: A Good Theory Gone Bad</u>, 59 Md. L. Rev. 595 (2000).

2. The Impact of the Marketing on Responsible Planning.

a. "Revocable trusts present many issues and the debate over their appropriateness as an estate planning tool has been going on for years. Some of the participants in this debate have confused the matter by fostering … the poplar misconception that a fully funded revocable trust is an appropriate will substitute, carrying with it untold advantages in money, time and complications saved. As a result, practitioners may often find themselves reluctantly picking sides between two apparent camps: those that like and always use revocable trusts, and those that dislike and prefer never to use revocable trusts." Jones, "Putting Revocable Trusts in Their Place," 129 *Trusts & Estates,* 8 (September 1990).

b. The estate planner's role is to neither blindly accept, nor blindly reject, the funded revocable trust as an estate planning tool.

II. The Taxation of Funded Revocable Trusts.

A. Federal Income tax Considerations – During Grantor's Lifetime.

1. Trust Income is Taxable to the Grantor.

a. The income generated by the funded revocable trust is taxable to the grantor due to the operation of the grantor trust rules. I.R.C. Secs. 671-677.

(1) "Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust" deemed owned by the grantor or such other person. I.R.C. Sec. 671.

(a) The power to revoke causes the grantor to be taxed on trust income. The grantor is deemed the owner "where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both." I.R.C. Sec. 676. Presumably, this attribute is always present in revocable trust.

(b) "Treating the grantor as owner of such a trust is appropriate, because the power to revoke represents absolute and complete control over the trust property." Lane & Zaritsky, *Federal Income Taxation of Estates and Trusts*, ¶ 9.02, 9-3 (Warren, Gorham & Lamont, 2004).

(c) Although revocation is the primary cause for a revocable trust to be taxed to the grantor, other grantor trust rules may likewise cause such treatment even if the trust is irrevocable:

(i) Income retained for the benefit of the grantor causes the grantor to be taxes on trust income. I.R.C. Sec. 677. Thus, if the trust pays the grantor's (or his or her spouse's) living expenses or discharges a legal obligation of the grantor, it will be taxed as a grantor trust. Treas. Reg. Sec. 1.677(a)-1(d).

(ii) Retaining the power to control beneficial enjoyment of corpus or income causes the grantor to be taxable on trust income. I.R.C. Sec. 674.

(iii) Retaining certain administrative powers will also cause the grantor to be taxed on trust income. I.R.C. Sec. 675. Thus, the power to borrow trust assets without adequate interest or security will cause the grantor to be taxed. I.R.C. Sec. 675(2); Rev. Rul. 85-13, 1985-1 CB 184; Rev. Rul. 86-82, 1986-1 CB 253; *Benson v. Comm.*, 76 T.C. 1040 (1981).

b. The general rule is that the transfer of property to a revocable trust has no federal tax impact. For example, certain tax benefits available to individuals have been specifically held to continue after a transfer into the trust.

(1) The holding period of any asset transferred to the trust is tacked to the grantor's holding period. GCM 19347, 1938-1 CB 218, declared obsolete on other grounds. Rev. Rul. 73-209, 1973-1 CB 614. If death makes the revocable trust irrevocable, the beneficiaries are deemed to receive a long-term gain holding period. I.R.C. Sec. 1223 (11) and (12) and Notice 97-59 (10/27/97) (I.R.B. 1997-45); Sec. 5001(a) of the Tax Reform Act of 1998. The long-term gain holding period applies to persons receiving property from a decedent.

(2) Because the grantor is treated as the taxpayer, grantor trusts are permitted shareholders of S corporation stock. I.R.C. Sec. 1361(c)(2)(A).

(3) The grantor will be treated as the owner of a personal residence for purposes of the exclusion of gain provisions under I.R.C. Sec. 121 as amended by the Taxpayer Relief Act of 1997 (excluding $250,000 of gain for single taxpayers and $500,000 of gain for married taxpayers). See PLR 200104005 which holds that the surviving spouse's interest in a residence held by a revocable trust qualifies for § 121 treatment but that portion of the joint trust that becomes irrevocable due to the other spouse's death does not qualify for § 121 treatment except to the extent of the 5+5 power held by the surviving spouse. The Service rejected the argument that a right to live in the residence by the surviving spouse should qualify the other half. The now repealed roll-over under I.R.C. Sec. 1034 (and the old "roll-out" under prior I.R.C. Sec. 121) of gain

on the sale of the principal residence likewise held that favorable treatment was not affected by placing the house in a revocable trust. PLR 9912026; PLR 9026036, Rev. Rul. 66-159, 1966-1 CB 162. Also see, *Frank MacBoyle Lewis Trust B v. Comm.*, 83 T.C. 246 (1984), where a testamentary trust and the widow were co-owners of the residence. The trust was to distribute all income to the widow during her life but corpus distributions were at the discretion of an independent trustee. The Tax Court held that the widow could "roll-over" her one-half share but the trust could not have a "principal residence" and therefore no roll-over for the otherwise one-half. The widow's residential attributes were not deemed to qualify the part held by the trust.

(4) The transfer of an installment obligation to a revocable trust does not accelerate gain. Rev. Rul. 74-613, 1974-2 CB 153.

(5) The IRS holds that because the grantor and the trust are one, no sale can occur between the two and no bona fide debt obligation can be created between them. Rev. Rul. 85-13, 1985-1 CB 184. See, however, *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984) which upheld a sale of stock to a grantor trust for an installment note resulting in an increase in the stock basis. This is a doubtful result. See Huffaker & Kessel, "How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts," J. Tax (WG&L) (April 2004).

c. Although the grantor trust rules generally shift the trust income to the grantor, some commentators speculate that the creation of a revocable trust may have certain adverse income tax results.

(1) Incentive stock options transferred to a revocable trust raise questions. Generally, the ISO must be exercisable by the individual grantee only during lifetime or by the laws of descent and distribution at death. I.R.C. Sec. 422. "Revocable Inter Vivos Trusts," 468-20 Tax Management Estates, Gifts and Trust Portfolios at A-35.

(2) Additionally, there is a concern that a transfer of small business stock to a grantor trust may violate the § 1244 stock rules which provide that an "individual" may treat his or her loss under certain circumstances as ordinary rather than capital at the end of a sour venture. Under the statute, "individual" does not include a "trust." I.R.C. Sec. 1244(d)(4); Miller and Rainey, "Dying with the 'Living' (or 'Revocable') Trust; Federal Tax Consequences of Testamentary Dispositions Compared," 37 *Vanderbilt Law Review* 811, 816 (1984).

2. Filing Requirements.

a. Generally, revocable inter vivos trusts have simplified reporting and filing requirements. Regs. Sec. 301.6109-1(a)(2); 1.671-4(b)(2)(i)(A).

(1) If the trust is taxable to a single individual (or spouse filing a joint return) under the grantor trust rules and certain alternative reporting requirements are followed, no taxpayer I.D. is required. The alternative reporting requirements require the trustee to give payors (brokers, etc.) the grantor's social security number (or other taxpayer I.D.). If the grantor is a trustee or co-trustee, nothing else is required.

(2) If the grantor is not a trustee or co-trustee and the procedure is followed permitting dispensing with an I.D. for the trust, then the trustee must also furnish the grantor with certain information to permit the inclusion of the income on his or her tax return.

(3) An alternative method permits the trust to secure a taxpayer I.D. number and to issue 1099's to the grantor/beneficiary.

b. For a detailed explanation of these reporting and filing requirements, see the discussion "Optional Filing Methods for Certain Grantor Type Trusts" contained in the Instructions for Form 1041.

B. Federal Gift Tax Considerations.

1. Impact Upon Creation of the Trust.

a. The revocability means that there is no completed gift upon creation and therefore no gift tax is triggered. Treas. Reg. Sec. 25-2511-2(c).

(1) The later incapacity of the grantor will probably not make the trust irrevocable thus causing a gift tax event. In *Brent v. State Cent. Collection Unit*, 311 Md. 626 (1988), a testamentary trust with spendthrift provisions contained a "carve-out" provision whereby a beneficiary could withdraw trust corpus upon reaching set ages. When the beneficiary, in fact, reached those ages, she was incompetent and therefore never exercised the "carve-outs." The Court of Appeals held that the beneficiary's incompetency had no bearing on the right to withdraw the funds, her disability merely affected her ability to demand the corpus. See also *Gilchrist Est. v. Comm.*, 340 F.2d 603 (5th Cir. 1980) where incompetency of holder of power to appoint property did not change includibility under I.R.C. Sec. 2041 and *Armata v. U.S.*, 494 F.2d 1371 (Ct. Cl. 1974) holding power to modify or revoke continues to exist because grantor's representative could exercise these powers. The IRS has consistently followed this approach. See Rev. Rul. 55-518, 1955-2 CB 384; Rev. Rul. 75-350, 1975-2 CB 366; Rev. Rul. 75-351, 1975-2 CB 368. Generally, a transfer is not a completed gift if the grantor's creditors can still reach the trust assts. Rev. Rul. 76-103 1976-1 CB 293; *Outwin v. Commissioner*, 76 T.C. 153 (1981).

(a) Moreover, drafting around this potential issue is relatively painless by providing a testamentary power of appointment to the grantor. Such a power also means that there is no completed gift for federal tax purposes. Treas. Reg. Sec. 25.2511-2(b). It is important, however, if avoiding probate is a goal, not to exercise powers of appointment in the will.

2. The Gift From the Trust Problem Solved.

a. For gifts made from revocable trusts for decedents dying before August 5, 1997, problems arose when making a gift purportedly under the annual exclusion provision from a trust.

(1) In 1990, the IRS issued several rulings that held that certain gifts from trusts may be treated as a termination of a power to revoke under I.R.C. Sec. 2035, rather than simply a gift from the grantor under I.R.C. Sec. 2503(b).

(2) If accorded I.R.C. Sec. 2035 treatment, gifts made within 3 years of death would come back into the grantor's gross estate for tax purposes.

(3) The rulings look to the terms of the trust instrument to determine whether or not the gift is actually a termination of a power to revoke. If the trust instrument permits distributions to someone other than the grantor, it is a termination of the power. If the trust instrument only permits payments to the grantor, the gift is deemed to flow through the grantor and thereby is properly excludible. In addition, if the trust is to terminate at death in favor of the probate estate, the gift gets exclusion treatment. This latter instance, of course, is unlikely as the presumed purpose of the trust is to "avoid probate." TAM 901004 and TAM 901005; Keydel, "Gifts Made from Revocable Trusts," 4 *Probate & Property* 51 (September/October 1990). The approach taken by the 1990 rulings is reflected by the case law. Est. of Perkins v. U.S. , 90-2 USTC ¶ 60,042 (D. Ohio 1990); Est. of Jalkut, 90 T.C. 675 (1991), *acq* 1991-2 CB 1.

(4) The IRS theory took various direct hits in court rulings. *Est. of McNelley v. U.S.*, 16 F.3d 303 (8th Cir. 1994); *Est. of Kisling v. Comr.*, 32 F.3d 1222 (8th Circ. 1994).

(5) See Action on Decision 1995-0062, acquiescing to *Est. of Kisling*, supra.

"It has been determined that to the extent that a transfer from a revocable trust (either outright or segregated within the trust within the trust) directed by the decedent or a guardian can be properly recharacterized as a withdrawal followed by a gift, the issue of relinquishment of a power of revocation should no longer be raised. Accordingly, the Service will no longer litigate the relinquishment issue where the decedent possesses a power to withdraw trust corpus or direct distributions to himself, regardless of whether the decedent also possesses the power to so direct distributions to other distributees. However, in other factual situations, the Service may continue to litigate the issue of whether there has been a relinquishment of a power under sections 2035 and 2038. For example, in the situation where the decedent establishes an irrevocable trust with the income interest for life to B and remainder interest to C but the decedent retains the power to change beneficiaries other than to himself, the decedent's gross estate will include the value of the trust if the decedent relinquishes the power to change beneficiaries within three years of the date of the decedent's death."

b. Corrective legislation was passed as part of the Taxpayer Relief Act of 1997.

(1) Now, for estates of decedents dying after August 5, 1997, transfers from a revocable trust are treated as coming directly from the grantor. Thus, an annual exclusion gift from such a trust is not includible in the gross estate.

c. Gifting by an agent under a durable power of attorney raises issues. The only "modern" Maryland case held that the agent must have an explicit power to make gifts. *King v. Bankerd*, 303 Md. 98 (1984). In addition, a Fourth Circuit case held that the power to gift must be clearly permitted under state law or it will not be honored for federal tax purposes. *Est. of Casey v. Comm.*, 91-2 USTC 60,091 (11/4/91) (under Virginia law).

d. Effective after October 1, 1999, the Maryland Circuit Court has explicit power to "authorize or direct" a guardian to make gifts or disclaim property. *Estates and Trusts Article*, Annotated Code of Maryland, Sec. 13-203(c).

(1) For earlier years, Circuit Courts have permitted disclaiming in proper cases.

C. Post-Mortem Federal Income Tax Considerations.

1. In General, Section 645 Election.

a. There are numerous differences in the post-death treatment of trusts, on the one hand, and decedent's estate, on the other. These differences can be largely avoided if an election under I.R.C. Sec. 645 is made to treat the trust as an estate (see below). Therefore, any review of the post-death differences should be against the backdrop of whether a Section 645 election should be made.

2. Passive Activity Loss Treatment.

a. Under I.R.C. Sec. 469, "passive activity losses" are not deductible against other income. A "passive activity" is the conduct of a trade or business where the taxpayer does not "materially participate."

(1) For trusts, the issue has been who must materially participate – the trustee or the trust itself.

(2) In *Mattie L. Carter*, 91 A.F.T.F. 2d 2003-1946 (2003), the court held that the trust, not the trustee must materially participate.

b. Real estate rental losses generally are deemed losses from a "passive activity" and therefore only deductible to the extent that the taxpayer has gains from other passive activities. I.R.C. Sec. 469. An important exception to the passive loss offset rule is afforded to taxpayers with less than $100,000 in gross income (with phase out treatment between $100,000 and $150,000).

(1) These taxpayers may deduct up to $25,000 in passive losses against other income if the taxpayer actively participates in the activity.

(2) Estates (but not trusts) qualify for the $25,000 treatment for two years. I.R.C. Sec. 469(i). The full $25,000 amount must be reduced by the amount allowable

to the surviving spouse for any given tax years. The two year period is two tax years so a "short year" uses up one of the years.

(3) "Corrective" legislation -- extending parity to trusts – was in the Tax Simplification Bill of 1991 (Sec. 441) which died at the end of 1991 without action. The Taxpayer Relief Act of 1997 added I.R.C. Sec. 646 (now renumbered Sec. 645) to permit certain trusts to elect estate treatment. See below.

3. Other Losses During Administration.

a. Losses were permitted to estates (but not trusts) upon a sale or exchange of property with a beneficiary because the relationship between an estate and the beneficiary of an estate were not treated as "related" for purposes of I.R.C. Sec. 267.

(1) This rule permitted estates (but not trusts) to elect to recognize losses on distribution of depreciated assets to a beneficiary. I.R.C. Sec. 643(e).

(2) The Taxpayer Relief Act of 1997 amended the law to include an executor of an estate and the beneficiary as related parties under I.R.C. Sec. 367.

(3) The 1997 amendment, however, did <u>not</u> change the rule "in the case of a sale or exchange in satisfaction of a pecuniary bequest." I.R.C. Sec. 367(b)(13).

(4) The result of the change to I.R.C. Sec. 267 means that losses upon in-kind distributions are no longer generally available under a Sec. 643(e) election, but are still available if the depreciated property is used to fund a pecuniary bequest.

(5) "This new restriction effectively revokes the I.R.C. Sec. 643(e) election to treat funding in-kind distributions as a taxable event when this involves a depreciated asset and a deductible loss otherwise would have been created. The realization of a loss can now only occur when the distribution of a passive activity is made in funding a pecuniary bequest, and not as heretofore, upon Sec. 643(e) election in a funding of a fractional share or residuary bequest." Abbin, "Income Taxation of Fiduciaries and Beneficiaries" (Panel, 1990) at 760.

b. Thus, losses are recognized by estates (but not trusts) when a pecuniary legacy – including, of course, a marital pecuniary bequest – is satisfied by a distribution in kind. I.R.C. Sec. 267 prohibits the trust from recognizing losses upon the distribution of property in kind. [Sec. 267(d) excludes from income of the beneficiary any gain attributable to the disallowed loss in a later sale of the asset.]

c. "A fiduciary who wishes to dispose of an asset with a basis higher than its current market value should usually sell the asset and distribute the proceeds to the beneficiaries, rather than distributing the asset in kind. The fiduciary can then deduct the recognized loss on the sale and use that loss to offset gains it may have or as the basis for a capital loss carryover." Lane & Zaritsky, *Federal Income Taxation of Estates and Trusts,* ¶ 4.11[1][c], (Warren, Gorham & Lamont, 2004).

3. S Corporation Stock.

a. I.R.C. Sec. 1361(c)(2)(A)(ii) permits a revocable grantor trust which becomes includible in the deceased grantor's estate to be a qualified shareholder for two years after the grantor's death. An estate, on the other hand, may be a qualified shareholder for the entire period of its reasonable administration. I.R.C. Sec. 1361(b)(1)(B). [For a case of an "unreasonable" period of administration, see Old Virginia Brick Co. v. Comm'r., 367 F.2d 276 (4th Cir. 1966) (after 18 years of estate administration held to become a "trust" and therefore not a qualified S corporation shareholder).

(1) "S corporation stock is generally a poor choice for lifetime funding of a revocable trust because of the additional restrictions imposed post-death when it is held in the decedent's revocable trust rather than his estate … [I]f complications arise (e.g., a Will contest, etc.), two years could prove to be woefully inadequate." Jones, "Putting Revocable Trusts in Their Place," 129 *Trusts & Estates* 8, 12 (September 1990).

(2) "There is a mistaken belief, held by even very competent professionals, that living trusts are not suitable entities to hold or to distribute subchapter S stock." Esperti and Peterson, "Post-Mortem Planning Differences for Estates and Trusts," *Trusts & Estates* 14, 22 (February 1992).

b. The Small Business Job Protection Act of 1996 created a new category under I.R.C. Sec. 1361 to provide that an electing "small business trust" will be a qualified S corporation shareholder.

(1) "The provision allows stock in an S corporation to be held by certain trusts ("electing small business trusts"). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under Sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc." House Committee Report.

(2) The trust is the taxpayer, not the beneficiaries. According to the Conference Report, these trusts are taxed at the highest individual rate.

4. Flexibility as to Tax Year/Estimated Tax Payments.

a. Estates (but not trusts) may elect to use a fiscal year. Trusts must use calendar years. I.R.C. Sec. 645.

(1) "This fiscal-year election may be extremely important if the estate is expecting a large lump sum of income. The personal representative could elect a taxable

year ending on the last day of the month preceding receipt of the lump sum income. Thus, the estate would have approximately sixteen months of deferral before income tax on the lump sum income would need to be paid." Altman, "A Will is still the Way," 23 *Beverly Hills Bar Journal* 460, 465 (Summer 1989).

b. Under I.R.C. Sec. 6654(1), estates (but not all trusts) are exempt from making estimated tax payments for taxable years ending within two years of the decedent's death.

(1) Grantor trusts where the decedent was the deemed "owner" qualify for the two year relief from paying estimated taxes if (i) the residuary estate pours over to the trust, or (ii) the trust is primarily responsible for paying debts, taxes and expenses of administration and no will has been admitted to probate. I.R.C. Sec. 6654(1)(2)(B).

5. Separate Share/65-Day Rules.

a. Under I.R.C. Sec. 663(b), distributions made within a period of 65 days after the close of the tax year may (at the election of the fiduciary) be considered as made before the close of the tax year. Before the Taxpayer Relief Act of 1997, this was only available to trusts. (Effective for tax years beginning after August 5, 1997, this rule applies equally to estates.)

(1) This rule is useful to "fine tune" distributions after the financial reports are reviewed. The election is on "any amount or portion thereof" so the fiduciary may choose which distributions to treat as deemed to be made in the earlier year. There are restrictions on the total amount of distributions, however, that may be treated as falling within the prior year. The total distributions elected for inclusion may not be greater when combined with all other distributions than the accounting income or the DNI for the 65-day period. Treas. Reg. Sec. 1.663(b)-1(a).

(2) The fiduciary must elect the 65-day rule on the tax return. Treas. Reg. Sec. 1.663(b)(2).

b. Under I.R.C. Sec. 663(c), for the sole purpose of determining DNI, a trust having more than one beneficiary, the "substantially separate and independent shares" of each beneficiary shall be treated as separate shares. See Treas. Reg. Sec. 1.663(c)-3(e) and 4 for examples of the application of this rule.

(1) Estates are now subject to the rule by virtue of the 1997 Act.

6. Throwback Rules.

a. Generally, the throwback rules no longer apply to domestic trusts because of the Taxpayer Relief Act of 1997.

(1) Repeal of these rules do not apply to trusts created before March 1, 1984.

7. Personal Exemptions.

a. For estates, the exemption is $600.00. For trusts the exemption is either $100.00 or $300.00 (if it must distribute all income currently). I.R.C. Sec. 642(b).

8. Charitable Set Asides.

a. Under the general rule of I.R.C. Sec. 642(c)(1), estates and trusts both are entitled to charitable deductions for "any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid" to a charity.

b. Under I.R.C. Sec. 642(c)(2), however, only an estate (and some grandfathered trusts) qualify for an income tax deduction from income derived from assets permanently set aside for charity. This means that the profits from such assets (including the gain from the sale of such assets) are not includible in estate income regardless of whether there is a corresponding distribution of such income in that taxable year.

(1) The set aside must be definite – so that the charity will presumably receive the benefit of the income. The deduction has been upheld regardless of the pending litigation that challenged the charitable bequest. *Rockland Oil Co. v. Comm'r.*, 22 T.C. 1307 (1954).

(2) If the trust instrument permits such a distribution, of course, an actual distribution from a trust to charity is deductible.

c. A Section 645 election will give trusts the charitable set-aside treatment of estates.

9. Joint Tax Return.

a. The personal representative "who is actually appointed to such office and not the person who is not the person who is merely in charge of the property of the decedent" may make an election with the decedent's surviving spouse to file a joint income tax return. Treas. Reg. Sec. 1.6013-4(c)(1).

(1) Also, only the statutory personal representative may consent to gift splitting in a situation where the return needs to be signed after one spouse has died. Treas. Reg. Sec. 25.2513-2(c).

10. Election Under I.R.C. Sec. 645 to treat Revocable Trusts as part of probate estate.

a. The Taxpayer Relief Act of 1997 provided for an irrevocable election whereby the trustee of a "qualified revocable trust" may elect to have the trust treated as part of the estate for income tax purposes. I.R.C. Sec. 645. Final Regulations were issued in December 2002.

(1) To qualify for the election, the trust or portion of a trust was treated as a grantor trust during the grantor's lifetime under I.R.C. Sec. 676. Thus, the grantor had the power (either alone or with a non-adverse party – like the spouse) to revoke any portion of the trust. The Regulations clarify that if an agent or legal representative of the settlor can revoke or amend after the settlor's incapacity, then the trust will be deemed a qualified revocable trust even if the settlor becomes incapacitated prior to death.

(2) The election is available if the grantor died after August 5, 1997. Once made, it is irreversible.

b. The election must be filed not later than the time for filing the estate's first 1041 (taking into account extensions). Rev. Proc. 98-14, 1998-4 I.R.B. 21.

(1) The election is made by attaching an original statement with the estate's initial income tax return.

(2) A copy of the "Required Statement" must be attached to the first 1041 submitted by the trust after the grantor's date of death. [This could be due before the estate's 1041 is due!] No 1041 is due for the trust if (i) the entire trust is a qualified revocable trust, (ii) the personal representative files a 1041 for the estate before the due date for the one for the trust, and (iii) trust items attributable to the deceased grantor are reported on his or her final return without the necessity of a 1041 (under the alternate options). If a 1041 has been filed by the trust without the election, an amended 1041 is required with the election.

c. The Required Statement under the election must be signed by <u>both</u> the personal representative and the trustee.

(1) If there is no probate estate, and therefore no personal representative, the trustee signs the statement and states that no personal representative exists and none will be appointed.

(2) If there will be no personal representative, the trustee signs all of the estate's income tax returns.

d. The duration of the election depends on whether a federal estate tax return is required.

(1) If no 706 is due, the election lasts for two years after the date of death.

(2) If a 706 is due, the election lasts six months after the date of a "final determination of the liability for tax."

(3) Query: When is a final determination of liability? When the 706 is filed in an unaudited estate? When the limitations on assessment expire? When the Sec. 2032A or 2033A recapture statutes expire if such an election was made?

D. Death Taxes.

1. Federal Estate Tax.

a. A decedent's gross estate for federal purposes includes the value of the revocable trust. I.R.C. Sec. 2038 (retained power to revoke); I.R.C. Sec. 2036(a)(1) (decedent's retention of the income rights); I.R.C. Sec. 2036(a)(2).

(1) A revocable trust may be drafted to provide for a credit shelter disposition, so a revocable trust may be designed to secure the same federal estate tax advantages of a properly drafted will.

b. Basis Step-Up Treatment.

(1) The income tax basis result is likewise parallel. I.R.C. Sec. 1014.

(2) A current theory holds that joint spousal trusts can step-up the basis of the entire amount of the property held by both spouse. PLR 20010121 ruled in favor of the taxpayer on a joint trust but did not give a full "green light" to the technique. Also, of course, letter rulings cannot be relied upon. Nevertheless, it is a technique that may gain currency.

2. State Inheritance Tax.

a. The "clear value" of a revocable trust is used to fix Maryland Inheritance Tax. Sec. 7-201(d)(1)(iii), *Tax-General Article*, Annotated Code of Maryland.

(1) "[E]xpenses ordinarily deducible from probate assets to determine clear value for imposition of inheritance tax are likewise deductible from non-probate assets when the instrument creating the non-probate estate expressly provides payment of such expenses." 81 Op. Attorney Gen. (Op. # 96-008) (1996).

(2) The Attorney General holds that Maryland real property held by a non-Maryland domiciliary in a trust is taxable in Maryland. 55 Op. Attorney Gen. 361 (1970). See *Dept. of State Rev. v. Estate of Pushel*, 583 N.E. 20923 (Ind. Tax 1991) for a different approach.

III. Trusts as Designated Beneficiaries of IRA's (and Qualified Plans).

A. Background.

1. The Minimum Distribution Rules.

a. IRA's and Qualified Plans grow tax-free and therefore the longer one can defer withdrawing funds, the better the potential for asset accumulation.

(1) Until distributions, the funds in an IRA (etc.) are not taxed.

b. Minimum distribution rules exist to compel distribution of an IRA during lifetime.

(1) If one violates the minimum distribution rules, a penalty equal to 50% of the amount required to be distributed is imposed.

c. If living, the owner of an IRA must begin taking distributions on or before April of the year after he or she reaches 70½ – the required beginning date.

2. Death Before the Required Beginning Date.

a. If one dies before his or her required beginning date, the entire amount must be paid out by the end of the year five years after death.

b. An important exception to the five year rule is when there is a designated beneficiary in place at death.

(1) If a designated beneficiary is named, then the beneficiary may be paid over the life expectancy of the beneficiary provided distributions begin no later than December 31 of the calendar year following the death.

c. Spouses qualify for spousal treatment, including rollover potential.

B. Trust as Designated Beneficiaries.

1. Final Regulations were issued April 2002 that liberalized the use of trusts as "designated beneficiaries." Generally, a designated beneficiary is "an individual who is entitled to a portion of … (the) benefit." Reg. 1.401(a)(9)-4A-1.

2. Only certain trusts will be permitted as a designated beneficiary.

a. The trust must meet three requirements under the regulations:

(1) The trust must be valid under state law. Or be valid but for the fact that there is no corpus.

(2) The beneficiaries of the trust must be identifiable from the trust instrument. The list of beneficiaries must be given to the plan administrator by October 31st following the participant's death.

(3) The trust must be irrevocable at the death of the plan participant.

IV. Non-Tax Distinctions.

A. Avoiding the Cost of Probate.

1. The "Probate Fee."

a. In Maryland, the probate fee schedule is set according to the value of the probate estate. Sec. 2-206, *Estates and Trusts Article*, Annotated Code of Maryland. Examples of the amount of the fee is as follows:

(1) $500 for estates $250,000 to $500,000.

(2) $1,500 for estates $1 Million to $2 Million.

(3) $2,500 for estates $2 Million to $5 Million.

b. These charges would not justify the creation of funded revocable trusts.

2. Commissions and Legal Expenses.

a. The personal representative is entitled to "reasonable compensation for services." Statutory commissions for personal representatives are expressed as a maximum: not to exceed $1,800 plus 3.6% of the excess over $20,000 unless a larger amount is provided by the will. Sec. 7-601, *Estates and Trusts Article.*

(1) Often a family member who is the primary heir is named as personal representative (e.g. the spouse) thereby adding planning potential. The top marginal rate for federal estate tax purposes is substantially higher than the top marginal income tax rate.

(2) If there is a separately stated attorney fee, the Orphans' Court shall permit such a fee but it "shall take into consideration in making its determination, what would be a fair and reasonable total charge for the cost of administering the estate under this article, and it shall not allow aggregate compensation in excess of that figure." Sec. 7-602, *Estates and Trusts Article.*

(a) In practice this usually caps the combined total at the "statutory rate" under Sec. 7-601 unless extraordinary circumstances merit special consideration.

(b) Note that a separate provision authorizes litigation expenses – including counsel fees. Sec. 7-603, *Estates and Trusts Article.*

b. Trustees are likewise entitled to commissions for their services in administering a trust. These commissions are two-fold: an income based commission and a commission based on corpus. The income portion is graduated from 6.5% on the first $10,000; 6% on the next $10,000; 4% on the next $10,000 and 3% thereafter. Commissions on managing real estate rentals, mortgages or ground rents, however, is a flat 6%. The corpus commissions are also graduated: 0.4% on the first $250,000; 0.25% on the next $250,000; 3/20ths of 1% on the next $500,000 and so on.

c. Regardless of the statutory scheme, professional advisors are going to seek compensation for services.

B. Avoid the Time and Legal Entanglements Involved in Probate.

1. Time Considerations.

a. The federal code requires that the personal representative pay the federal estate tax. This obligation extends to that part of the estate tax generated by non-probate property never coming into the personal representative's hands. I.R.C. Sec. 2002; Treas. Reg. Sec. 20.2002-1. If the personal representative distributes property (whether to an heir or to pay a debt out of the order of priority), he or she is personally liable to the extent of such distribution. Thus, a personal representative may wish to retain assets until receiving a discharge from personal liability from the IRS. I.R.C. Sec. 6905. Another approach is to request a prompt assessment of income or gift tax to shorten the time from three years to eighteen months. I.R.C. Sec. 6501(d).

b. The trustee of an inter vivos trust is exposed to transferee liability. This liability is different than that of the personal representative. "If such trustees properly distribute or pay over trust funds before the IRS serves them with a notice of transferee liability, they should have a defense to liability." Lane & Zaritsky, *Federal Income Taxation of Estates and Trusts*, ¶ 16.04[8], (Warren, Gorham & Lamont, 2004).

(1) "Many fiduciaries are unwilling to run the risk of distributing assets before final settlement of tax liabilities, because the question of whether they had 'notice' of delinquencies cannot usually be answered with confidence." Id. At ¶ 16.04[11], 16-29.

c. On the other hand: "The use of a revocable trust avoids any hiatus in the management of the decedent's assets following his death. (This) may be extremely important if some of the assets are volatile and require close watching." Cornfeld, *"Loving Trusts or Hateful Wills*," 27 Inst. on Estate Planning, 13-21 (Miami 1993).

d. The "secret" estate tax lien of Sec. 6324 covers all property in a decedent's estate regardless of notice for ten years. Bona fide purchasers are discharged from the lien (Sec. 6324(a)(2) – the lien is transferred to the selling trustee), whereas bona fide purchasers from an estate are discharged only to the extent the proceeds are used for administrative expenses as allowed by a court of competent jurisdiction. Sec. 6324(a)(1).

(1) In addition, of course, this is the lien under I.R.C. Sec. 6321 arising after the tax is assessed and payment documented. This lien required notice.

e. The time to present claims against a decedent's probate estate is six months from death. *Estates and Trusts* § 8-103. Will contests run from the later of six months after the appointment of the personal representative under a probated will or three months after a later probate. Md. Rule 6-431(b). Contests dealing with the trust itself (for example, whether the death provisions were caused by undue influence) probably enjoy a three (3) year statute running from the death of the settlor (because it is, after all, revocable until death). See *Ullman v. Garcia*, 645 So. 2d 168 (Fla. 1994). For a creditor to claim against a revocable trust, however, presumably the creditor must first file a claim with the Register within the six (6) month window, then as a collection matter pursue the trust assets.

The Uniform Trust Code (2003) limits contests of a revocable trust to three years or 120 days from notice to the person wanting to contest. Notice includes a copy of the trust. The UTC, however, provides that the trustee may distribute per the terms of the trust without liability if the trustee does not know of a judicial proceeding to contest the trust or receive notice of the potential for such a proceeding and such a proceeding commences within 60 days of such notice.

2. Spousal Election.

a. To date, there is no definitive Maryland decision whether property in a revocable trust will be subject to the elective share rights of the settlor's surviving spouse.

(1) Under the Maryland statute, the spouse election section (Sec. 3-203 of *Estates and Trust Article*) purportedly acts against the probate estate. Indeed, the General Assembly considered and rejected the approach taken by the Uniform Probate Code (which applies the election against something akin to the federal estate tax definition of the gross estate – see Delaware law): "This Section (Estates Art. Sec. 3-203) follows generally 2-201 (UPA), except that it rejects the concept of the "augmented net estate" under which certain property which does not form a part of the estate passing under the will of the decedent is taken into consideration in determining the elective share of the surviving spouse." Second Report of the Governor's Commission to Review and Revise the Testamentary Law of Maryland (the "Henderson Commission"), Official Comment to Sec. 3-203 (1968).

(2) Nevertheless, if an inter vivos transfer is made to improperly circumvent the marital rights of the surviving spouse, such transfer may be set aside as a fraud on the surviving spouse's rights. For many years, the test was as stated in *Whittington v. Whittington*, 205 Md. 1, 106 A.2d 72 (1954); "completeness" of the transfer (also see *Brown v. Fidelity Trust*, 126 Md. 175 (1915)); motive for the transfer; participation by the transferee in the alleged fraud on the surviving spouse; amount of time between the transfer and death; degree to which the surviving spouse is left without an interest in the decedent's property or other means of support (also see *Kernan v. Carter*, 132 Md. 577 (1918)).

(3) The Court of Appeals revisited the issue. *Knell v. Price*, 318 Md. 501 (1990), involved a decedent who retained a life estate with power in his residence while "transferring" the remainder to his girlfriend. The decedent never gave up possession of the property, he continued to live in the residence, he retained the unrestricted power to mortgage or sell the residence, and generally he retained an "unfettered power to dispose of all interests in the property." Under the facts in *Knell*, the Court of Appeals found that this exercise of "absolute

dominion" made the purported "transfer" of the remainder ineffective. *Knell* does not overtly claim that a new standard is established.

(4) The Circuit Court for Howard County (Judge Dennis Sweeney) held that *Knell* created a *per se* rule so that all revocable trusts are subject to the spousal election. *Woodson v. Chamblee*, Howard County Case Number 90-CA-13168. The case was settled while pending in the Court of Special Appeals. To date, no appellate court has ruled directly on the issue.

b. In many jurisdictions, courts have made available property held by revocable trusts for the elective share.

(1) Usually, courts find revocable trust "illusory" because of the substantial control retained by the settlor. *Seifert v. S. Nat. Bank*, 409 S.E. 2d 337 (S.C. 1991); *Johnson v. Farmers and Merchants Bank*, 379 S.E. 2d 752 (W.Va. 1989); *Taliaferro v. Taliaferro*, 843 P.2d 240 (Kan. 1992); *McCarthy v. State Bank of Fredonia*, 796 P.2d 940 (Kan. 1990). (An IRA treated as a revocable trust for elective share purposes.)

(2) The issue of the availability of assets held at death in a non-probate trust, instead of by the estate, goes to the heart of the "'availing" probate resolution: "Transferors use will substitutes to avoid probate, not to avoid the subsidiary law of wills. The subsidiary rules are the product of centuries of legal experience in attempting to discern transferors' wishes and suppress litigation. Those rules should be treated as presumptively correct for will substitutes as well as for wills. Once we understand the will substitutes are nothing more than 'non-probate wills' and that no harm results from admitting the truth, we have no basis for interpreting will substitutes differently from wills." Langbein, "The Nonprobate Revolution and the Future of the Law of Succession," 97 Har. L. Rev. 1108, 1136-1137 (1984).

(3) Not all states subject property in a revocable trust to the elective share provisions. In *Soltis v. First of America Bank of Muskegan*, 513 N.W. 2d 148 (Mich. 1994), the court held: "Absent any showing of fraud upon petitioner's marital rights, we must conclude that decedent's assets in the inter vivos trust do not fall within the spousal election provision." Part of the court's analysis included the observation that the legislature specifically rejected an "augmented estate" approach when it amended the elective share statute. Given the comment by the Henderson Commission, the Maryland legislature could be seen as similarly rejecting an extension of the elective share statute.

c. An election by a surviving spouse against probate property, on the other hand seems to not cause forfeiture of rights as a beneficiary under a revocable trust. *Carnahan v. Stallman*, 504 N.E. 2d 1218 (Ohio 1986)) (Subsequently, Ohio reversed the result by statute.)

(1) "The significant drafting point is that the decedent-grantor can avoid the potential issue by stating in the revocable trust that if the surviving spouse takes the elective share he or she forfeits all trust interests." *Practical Drafting*, July 1993 at 3251.

d. The Estates and Trusts Section Council of the Maryland State Bar Association authorized a study of the elective share statute in light of *Knell* and suggested changes from time to time. Nothing is currently pending.

3. Litigation/Dispute Considerations.

a. Presumption of validity of gift/bequest. If a confidential relationship can be shown, an inter vivos gift is presumed invalid and the donee has the burden to establish, by clear and convincing evidence, that there was no abuse of confidence. With testamentary bequests, however, the existence of the confidential relationship is simply one suspicious circumstance to be considered. There is no presumption of invalidity. In *Upman v. Clarke*, 359 Md. 32 (2000), the Court of Appeals held that a gift to take effect at death contained in a revocable trust is testamentary and not inter vivos for the purpose of the presumption.

b. Probate Exception to Federal Jurisdiction. Under the "probate exception" to federal diversity jurisdiction, federal courts will not probate a will or administer an estate. But see *Marshall v. Marshall*, 126 S. Ct. 1735 (2006) (The Anna Nicole Smith bankruptcy case). This exception does not necessarily apply to revocable trusts. *Sianis v. Jensen*, ___ F.3d ____, (8^{th} Cir. 6/21/02): *Markham v. Allen*, 326 U.S. 490 (1946); *Aston v. Paul*, 918 F.2d 1065 (2d Cir. 1990). See Steve Leimberg's Estate Planning Newsletter, Commentary #433 (2002).

4. Maintaining Privacy.

a. "A Will that is admitted to probate must be filed in the public records of the probate court. For the client who cannot abide the thought of his dispositional plan being a public record, the entire dispositional plan can be set forth in a revocable trust and only a simple pour- over Will need be filed in the probate court records. Only if the client has the further concern of keeping his inventory private as well as does lifetime funding of the trust make sense." Jones, "Putting Revocable Trusts in Their Place," 129 *Trusts & Estates*, 8 (September 1990).

5. Planning for Disability.

a. Trusts are good vehicles for disability planning. For older clients and/or the client at great risk of a physically or mentally disabling condition, a standby trust, coupled with a durable power of attorney, is recommended. Unless the disabling condition is fairly certain, however, a funded trust may not be necessary. For younger, healthy clients a durable power of attorney is recommended.