

A Few Words About Joint Trusts

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Introduction

Over the past several decades, revocable trusts have become increasingly popular as substitutes for Wills. The use of a single revocable trust, created by and holding assets belonging to both spouses, is also on the rise. Although it is understood that such joint revocable trusts are used more often by couples residing in community property states, couples in non-community property jurisdictions who hold no community property are using joint revocable trusts as well.

In general, creating a joint trust has no tax effect. No gift is made for Federal gift tax purposes from one spouse to the other as long as (i) original ownership is preserved and (ii) the contributing spouse retains the right to recapture the property he or she has contributed to the trust. Of course, the assets each spouse contributes will be included in his or her gross estate for Federal estate tax purposes. The joint trust is a grantor trust for income tax purposes with respect to the assets each spouse contributed to it.

Additionally, it seems that couples are creating more joint *irrevocable* trusts, especially with community property. These trusts usually are intended to be excluded from each spouse's gross estate and are often structured to qualify gifts thereto for the Federal gift tax annual exclusion with respect to trust beneficiaries (e.g., the children of the couple).

Special issues often arise, making the apparent simplicity of having a married couple create a joint irrevocable trust somewhat deceiving. In many cases, these issues suggest that a joint trust may not be the most appropriate choice of transfer.

Issues to Consider

Accounting for Ownership

If the joint trust is revocable, disputes between the spouses (e.g., in the breakdown of a marriage) as to who really "owns" which assets in the trust may arise. As indicated above, joint revocable trusts usually provide that no change in ownership from the contributing spouse to the other spouse is intended, but proof of what assets belong to which spouse may not be as certain as it would be if the property of each spouse were contributed to his or her own separate revocable trust. Additionally, in some states, such as Texas, certain creditor rights are determined by both ownership and management rights.

Planning Flexibility

Another potentially troubling issue relates to estate planning flexibility. If one spouse makes the transfer of his or her separate property to a traditional single

grantor irrevocable trust, the other spouse may be a beneficiary without the creditor claim issues associated with "self settled" trusts and without risk of having the assets brought back into the estate of the contributing spouse for federal estate tax purposes. See, e.g., New York EPTL 7-3.1 and Outwin v. Commissioner, 69 T.C. 153 (1981). Making the non-grantor spouse a beneficiary of the trust may be wise because that may indirectly provide protection for the couple against the possibility that the trust assets are ever needed by the couple. Although it might be possible, while both spouses are alive, to provide for one spouse to be a beneficiary with respect to the other spouse's property contributed to a joint trust, record-keeping will be complicated, presumably requiring accounting for each spouse's property as though it were held in a separate trust. Additionally, it may be more difficult, in a joint irrevocable trust to positively establish, at least to the satisfaction of the IRS, that income from property contributed by a spouse is not distributed to that spouse leading to problems under the retained income rule of Code Sec. 2036(a)(1). In addition, a creditor of the contributing spouse might attempt to attach the property claiming that, in substance, the beneficiary spouse actually received income from the property he or she contributed to the joint trust. Cf. Everett v. Peyton, 167 NY 117 (1901).

Even if the trust created by one spouse includes a "second-to-die" policy on the lives of both spouses, the non-grantor spouse could be an eligible beneficiary of the trust without causing the proceeds payable on his or her death to be included in his or her estate. In all likelihood, this could not be accomplished if each spouse has contributed assets to the trust.

Reciprocal Trust Issues

If each spouse creates a separate trust at different times and provides for substantially different provisions for each other, neither trust should be included in the estate of either spouse's gross estate under the reciprocal trust doctrine. See, e.g., Greene v. U.S., 68 F.3d 151 (6th Cir. 1995).

Complications with Grantor Trusts

Additional complications relate to grantor trusts. There are several benefits to structuring a trust as a grantor trust, so that its income, deductions, and credits against taxes are attributed for Federal income tax purposes to the grantor. See, Gans, Heilborn & Blattmachr "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," Estate Planning, Vol. 31 No. 10, at 467 (October 2004). This permits appreciated assets to be sold from the grantor to the trust, or from the trust to the grantor, without gain recognition. See, Rev. Rul. 85-13, 1985-1 CB 184. It also permits the trust to extend credit (e.g., make a loan) to the grantor or allows the grantor to extend credit to the trust without the interest paid or imputed being subject to Federal income tax.

In addition, a grantor trust may purchase from or sell to its grantor a policy of insurance on the life of the grantor without triggering the "transfer for value" rule of Code Sec. 101(a)(2) which may cause the policy proceeds to be subject to income tax. The IRS has said that a grantor does not make a gift to a trust by paying income tax on trust income attributed to the grantor under the

grantor trust rules. See, Rev. Rul. 2004-64. This allows the trust to grow income tax free, producing a better overall estate planning result.

Some of the foregoing grantor trust effects may be achieved using a joint trust. And, of course, the trust may be a joint grantor trust. See, e.g., Reg. §1.671-4. For example, either or both spouses may sell appreciated assets to the trust without gain recognition. However, it is likely that each spouse would be treated as selling part of the asset to the part of the trust of which he or she is grantor and the balance to the part of the trust which the other spouse is grantor. Nevertheless, gain will not usually be recognized by reason of Code Sec. 1041 (sales between spouses treated as gifts rather than as sales for Federal income tax purposes). Although, if credit is extended (e.g., the joint trust buys assets for a note), the interest paid or imputed from one spouse to the other will be included in gross income as Code Sec. 1041 does not apply to interest. Whether the spouse treated as paying the interest will be entitled to an offsetting deduction for which the deduction would be limited will depend upon the specific facts involved. See Code Sec. 163.

Certainly, once one spouse dies, the ability of the survivor to sell to or buy appreciated assets from the joint trust, or to pay or receive interest without income tax effect, will be lost to the extent of the deceased spouse's contribution to the trust. Perhaps, the trust agreement could provide that a sale to a joint revocable trust by one spouse must be treated as sold *only* to the portion of the trust of which the selling spouse is the grantor. However no authority expressly supports this conclusion.

A purchase or sale between either or both spouses and their joint revocable trust of a policy of insurance, or the life of either or both spouses, should not render the proceeds paid at death to the income tax transfer for value: one spouse may sell an interest in the policy without gain recognition to the portion of the trust of which the seller is grantor (See Rev. Rul. 85-13) and receive an interest in the trust without gain recognition as to the portion of the trust of which the seller's spouse is grantor (Code Sec. 1041). Although the exceptions to the transfer-for-value rule (including the one for a purchase by the insured of a policy on his or her life) contained in the Code apparently have never been "developed" with respect to a policy insuring the lives of both spouses, it seems that the interests are either being sold to the insured spouse or to the insured himself through the application of Rev. Rul. 85-13 (which, in either case, should protect the proceeds paid at death from income tax). Again, the opportunity completely to avoid the transfer-for-value rule presumably will be lost when the first spouse dies (and grantor trust status to the extent of that spouse's contribution to the trust ends). Alas, in the event the couple divorces, opportunities to avoid adverse tax consequences thereafter most likely diminish.

Summary

Joint trusts in non-community property jurisdictions are rapidly growing in popularity. Some spouses may take "psychological" comfort in owning and transferring property together. However, disputes as to ownership may arise between the spouses with respect to assets in a joint revocable trust. Although it is unlikely that this problem will arise with respect to an irrevocable joint

trust, the ability to have at least one of the spouses benefit from the property while they are both alive is probably lost, although it need not be if the trust is created by only one spouse.

An additional significant limitation of joint irrevocable trusts is where it is desirable for the trust to be a grantor trust for income tax purposes. Although sales and exchanges between either or both spouses and the joint grantor trust may be made without certain income tax consequences, the results may not be as certain or as beneficial as they would be if only one spouse created the grantor trust and that spouse alone engaged in the transactions with the trust.