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Joint Trusts in a Separate Property State: Time For A Second Look?

By: Teresa Nuccio, Esq. and Robert P. Wolfson, Esq., CPA

The use of joint revocable trusts in a separate property state has been a controversial subject for over two decades. What most commentators agree upon, even those critical of their use, is that the joint trust can be an effective planning tool if used under appropriate circumstances and drafted properly.

With the federal estate tax exemption amount at an all-time high, such planning will likely become more popular, even though it can be appropriate in a taxable estate as well. The savvy planner will recognize when they are a good fit, when they are not advisable, and how to draft and fund them properly.

When Joint Trusts are the Right Choice

As with any strategy, counseling and identifying client goals are of paramount importance. Ideally, a joint trust is the vehicle of choice in "first and only" marriages where all non-qualified assets are jointly owned. Clients like them because they maintain the status quo and preserve the feeling that all property is "theirs." Moreover, there is no need to divide assets, so funding tends to be simplified. The joint trust can be a particularly good choice where clients express their intent to retire to a community property state in the future. With WealthDocx, the trust and ancillary documents are easy to draft, creating documents for both spouses at the same time. Thus, it enables clients of even moderate means to engage in sophisticated planning, preserving their privacy, planning for disability, avoiding probate after death and providing asset protection for beneficiaries.

Non-Tax Reasons for Separate Trusts

Joint trusts are not advisable in unstable or second marriage situations, where spouses have maintained separate accounts, or where husbands and wives have different beneficiaries and successor Trustees. Similarly, separate trusts are recommended if one spouse has acquired substantial property prior to marriage or has received gifts or inheritances during the marriage that he or she wishes to keep separate. Joint trusts are also contraindicated where one spouse has creditor issues or where Medicaid planning is on the horizon.

Tax Pitfalls to Avoid

Inadvertent triggering of gift tax may occur upon creation of a joint trust where each spouse contributes unequal amounts and the power to revoke or withdraw assets must be exercised jointly. A gift tax may also be triggered on the death of the first to die if the trust is irrevocable on the first death and the surviving spouse is not given a testamentary power of appointment over trust assets (See PLR 8617006). Fortunately, these problems have been

addressed and eliminated in the WealthDocx documents. However, these issues may still be relevant when working with documents drafted by others.

If the origins of assets are impossible to trace, determining step-up in basis and allocating assets to subtrusts will be problematic when the first spouse dies.

Other tax related issues involve funding S Corporation stock and life insurance beneficiary designations. While the initial transfer of jointly or separately owned S Corporation stock into a joint trust should not disqualify the trust, special attention should be given to avoid disqualification of subtrusts at the first spouse's death (See Treas. Reg. Sec. 1.1361-1(k)(1)). With life insurance beneficiaries, beware of cross-owned policies if you intend to fund the credit shelter trust. Make sure the intended sub-trust is designated as the beneficiary and not the joint trust. Otherwise, the IRS could argue that the surviving spouse made a completed gift to the remainder beneficiaries upon the deceased spouse's death (see PLR 86-17-006). Alternatively, the IRS could take the position that the proceeds are to be included in the surviving spouse's gross estate on his or her subsequent death (see IRC Section 2036).

The pitfalls noted in this section may be moot in a non-taxable estate or may be circumvented by proper drafting.

General Power Of Appointment Trusts

In two PLRs (200101021 and 200210051) each spouse gave the other a general power of appointment over all the assets held in a joint trust. The IRS ruled that a gift qualifying for the marital deduction was effectively made by the surviving spouse to the deceased spouse immediately prior to the deceased spouse's death, making the deceased spouse the "transferor" for gift or estate tax purposes, consequently allowing all trust assets (both husband's and wife's) to fund the credit shelter trust. Relying on these rulings, some practitioners have advocated the use of this strategy to avoid the tax issues previously mentioned. As a result, to accommodate those WealthCounsel attorneys who share this position, optional language has been included in the WealthDocx software to provide for this planning technique. However, the authors caution that PLR's do not have precedential authority and can be withdrawn by the IRS at any time (although admittedly, they do give us an idea as to how the IRS will address a particular issue). Furthermore, the WealthCounsel principals, among others, have expressed "serious concerns" as to whether this technique has continuing validity.

Drafting Joint Trusts Using WealthDocx

To avoid potential gift tax problems, WealthDocx includes language reserving the right of each spouse to remove assets he or she contributed to the trust at any time without the other spouse's consent, and reserving the right to revoke the trust as to the property contributed. WealthDocx also allows you to characterize property contributed to the trust as joint, community property, or separate property upon creation of the trust. Separate schedules may be appended, identifying property as joint, separate or community property. WealthDocx also offers ancillary property agreements in which to sever joint tenancy and characterize separate property.

Conclusion

If the joint trust has not been part of your toolkit, perhaps it is time to take a second look. Given the right circumstances, it might be an excellent strategy to provide your clients with a high caliber, psychologically satisfying estate planning experience.

About the Authors:
Teresa Nuccio is celebrating her 20th anniversary serving her clients in the areas of estate planning, special needs and elder law. Unique in the world of attorneys, Teresa holds a Master of Social work; this counseling background helps her guide her clients to arrive at their own decisions, for more satisfying conclusions. She has been named a Five Star Wealth Manager in Chicago Magazine for the past three consecutive years.

Robert P. Wolfson is engaged in the private practice of law in Naperville, Illinois, concentrating exclusively in the area of estate planning and administration. His practice consists of advising and serving a wide range of clients, including those of high and mid-range net worth levels. The majority of his clients come to him through referrals from CPAs, financial advisors, and other attorneys. He has nearly forty years' experience in the tax and tax planning field, including eight years with the Internal Revenue Services as both an agent and attorney, before entering private practice in 1985.

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