

Revocable Trusts for Changing Times

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Things change—often in unexpected ways. This axiom has certainly been true for estate planners, who have juggled near constant adjustments to state and federal laws over the last 10 years. The frequent movement of individuals and the evolution of the very nature of assets also conspire against well-meaning planning. It is no secret, then, that trust instruments need flexibility. How to do that depends on the circumstances of each client. Greater wealth and complexity may augur long-lasting trusts, while less wealth and less complexity may inform a simpler plan. Regardless, the need to be nimble is paramount. Many of the tools to do this are well known. Therefore, rather than break new ground, this article serves as a brief reminder and reexamination of options, focusing on planning for spouses.

For purposes of this article, a revocable trust is always the foundation of an estate plan. While revocable trusts have frequently been touted as a means of avoiding probate and doing so may be important in some states (like California), focusing on probate avoidance sells revocable trusts short. Their true benefit is as a means of managing finances during life and, critically, during incapacity. Because the client will be alive for the potential trauma of a personal conservatorship or guardianship of the estate, using a revocable trust to avoid those proceedings can spare the client from actual personal harm. Failing to use a revocable trust for incapacity planning purposes is often a missed opportunity.

Simple Revocable Trust

Even clients with limited means need the principal benefits of a simple revocable trust. A trust can provide a means of financial management that is not available in any other legal form in most states. For example, aside from the conservatorship avoidance, financial institutions tend to be more comfortable with trusts than powers of attorney, and they seem to have an easier time with a change of trustee when the terms of the trust instrument are clear about who is to serve and when. Trust property is also not the subject of probate at the death of a settlor, though the informal probate procedures of some states, such as those adopting the Uniform Probate Code, are less burdensome than the probate proceedings in other jurisdictions, such as California. Because the location of clients and property at the time of death can be difficult to predict, however, it is equally difficult to predict where a probate may be necessary when the client dies.

At the death of the first spouse, a simple revocable trust structure can essentially provide that nothing changes either by granting the survivor revocation and amendment powers over the trust, as in the case of a joint trust, or pouring the trust into the survivor's own revocable trust. Thus, the structure also allows for a streamlined administration at the first death.

Although a simple revocable trust provides the needed incapacity and probate planning, there are several drawbacks. First, the structure lacks control. To the extent that one spouse is interested in controlling the use of their property after their death, that is not an option with a simple revocable trust.

Second, the revocable and amendable nature of the trust holding the deceased spouse's property leaves

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the survivor vulnerable to influence. Exploitation is a significant concern with a simple revocable trust because, unless another party serves as trustee, the trust assets are essentially the survivor's personal assets. Thus, the simplicity of the trust leads to reduced barriers that can be exploited if the survivor becomes susceptible to others.

Third, the assets of a simple revocable trust can be subject to the claims of creditors, including future ex-spouses.

Finally, a simple revocable trust does not prioritize federal estate tax savings. If the federal estate tax basic exclusion amount drops below a spouse's net worth, a simple revocable trust would not provide any federal estate tax savings. See Marc S. Bekerman, *Credit Shelter Trusts and Portability: Does One Exclude the Other?*, Prob. & Prop., May/June 2011, at 10. Moreover, the future appreciation of the deceased spouse's assets would be held in the survivor's hands, thus increasing the survivor's federal estate tax exposure, and the benefits of portability would be lost if the survivor remarried and the subsequent spouse died. See Treas. Reg. § 20.2010-3(a). Additionally, if the federal transfer tax exemption levels fall in the future, the federal generation-skipping transfer tax (GST Tax) could become an issue for more clients. Portability does not include the transfer of unused GST Tax exemption. A simple revocable trust cannot solve this problem because, for GST Tax purposes, the individual in whose estate the assets were most recently included (i.e., the survivor) is the "transferor" for GST Tax purposes, and that person's GST Tax exemption must apply to the assets. See Treas. Reg. § 26.2652-1(a)(2). Thus, the first deceased spouse's GST Tax exemption goes unused with the simple revocable trust structure.

Despite these drawbacks, for the right client, a simple revocable trust might make sense because it is often less expensive. In the case of a joint trust, there would be no requirement to divide trust property at the death of the first spouse and no requirement to obtain an employer identification number and file separate tax returns for a new trust. For individuals of limited means, the cost savings could be critical. The trust instrument can have clear standards that permit an orderly change of trustee should the survivor become incapacitated or vulnerable to exploitation. The trustee also can manage the trust assets without significant expense consistent with a conservatorship or probate.

Disclaimer Bypass Trust

For individuals with some means, the disclaimer bypass trust has been a popular option for a long time. The premise of this trust structure is simple: After the death of the first spouse, the trust property is split into (i) a survivor's trust (in the case of a joint trust) or distributed to the survivor's own revocable trust and (ii) a bypass trust, depending on how much, if any, of the deceased spouse's trust property the survivor disclaims in a "qualified disclaimer." Thus, the survivor has the flexibility to determine whether the bypass trust will exist after the death of the first spouse when the facts and circumstances relevant to that decision might be clearer.

What the disclaimer bypass trust brings in flexibility, however, is often undermined by its technical complications. For example, (i) a qualified disclaimer must be exercised within nine months of the death of the first spouse, (ii) the survivor cannot have accepted any of the benefits of the property disclaimed, and (iii) the survivor may not, directly or indirectly, determine who benefits from the disclaimed property (meaning the survivor may not hold a power to appoint the disclaimed property). See I.R.C. § 2518.

While nine months may seem like a significant amount of time, if the trust includes hard-to-value assets, it may be challenging to obtain the needed appraisals to adequately evaluate the merits of disclaiming within that time period. The survivor also must maintain capacity to exercise the disclaimer or be covered by an adequate power of attorney granting that authority to another person. See Bekerman, *supra*, at 14.

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The functional ability for the survivor to avoid accepting the benefits of the disclaimed property over the course of months may also be almost impossible to achieve when property is held in a joint trust. The Treasury Regulations make it ominously clear that any act indicative of acceptance of benefits will constitute acceptance, including using the property, accepting dividends or interest, and directing others to act with respect to the property. Treas. Reg. § 25.2518-2(d)(1).

Although the survivor can be the beneficiary of the bypass trust to which the disclaimed property is directed, the survivor may not retain a power to appoint that trust. Thus, there is no direct way to alter the trust by a power of appointment should the circumstances of the beneficiaries or the laws change in the future. The lone exception would be a power of appointment subject to an ascertainable standard, but that is often impractical as a testamentary tool. *See* Thomas L. Stover, *Will the Tax Tail Still Wag the Estate Planning Dog?*, 41 Est. Plan. J. 3 (Mar. 2014).

The technical landmines mark the largest drawbacks to the disclaimer bypass trust. Because the bypass trust is frequently structured to be excluded from the survivor's estate for federal estate tax purposes, the property of the trust is not subject to an income tax basis adjustment at the death of the second spouse even if the survivor's gross estate does not exceed the federal estate tax basic exclusion amount and their deceased spousal unused exclusion amount. *See* I.R.C. § 1014(b).

Despite the drawbacks, the disclaimer bypass trust has the clear advantage of simplicity. In concept, the structure also gives some flexibility and time to make critical decisions after the death of the first spouse. With portability, should the first spouse die when their gross estate does not exceed the federal estate tax basic exclusion amount, the option to disclaim grants some measure of flexibility to use or retain the unused federal estate tax basic exclusion amount for the survivor. The GST Tax exemption of the first deceased spouse may also be allocated to the bypass trust, if there is one, thus preserving the GST Tax exemption.

A/B or A/B/C Trust

For many years, the default in trust planning was the so called "A/B" or even "A/B/C" trust. The mechanics of either came in one of two forms with one of two funding formulas. First, at the first spouse's death, the trust property was split into two or three trusts. In a joint trust estate plan, the deceased spouse's federal estate tax basic exclusion amount was held in a bypass trust (the B trust), and the balance of the trust was held in the survivor's trust (the A trust) or, alternatively, split between the survivor's trust and a qualified terminable interest property trust (QTIP Trust) (the C trust). In a separate trust estate plan, the deceased spouse's federal estate tax basic exclusion amount was held in the B trust and the balance either added to the survivor's own revocable trust or contributed to a C trust. Second, the determination of the bypass trust amount was either determined based on a pecuniary dollar amount equal to the available federal estate tax basic exclusion amount or a fraction derived therefrom. Sometimes, the dollar amount or fraction were determined based on the minimum amount that needed to be funded into the QTIP Trust to eliminate the federal estate tax liability at the death of the first spouse.

This planning is outdated under current law and does not provide much flexibility. With the currently high federal estate tax basic exclusion amount, and the loss of income tax basis adjustment for any assets in the bypass trust, being locked into creating a bypass trust is a blunt instrument for a discrete problem. There may be no tax need for the bypass trust at the death of the first spouse, but with the A/B or A/B/C trust structure, there could be no easy way out of its funding. Some practitioners attempt to address this concern by including a conditional general power of appointment or causing the survivor to trigger the so-called Delaware tax trap. *See* I.R.C. § 2041(a)(3), (b)(1). Either result would cause the bypass trust assets to be included in the survivor's estate, thus allowing the tax basis adjustment at the survivor's death. *See*

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id. § 1014(b). In the case of the general power of appointment, however, it may also require opening the class of permitted appointees to unintended individuals or entities, such as creditors.

Yet some clients may still prefer an A/B or A/B/C trust structure for a few reasons. First, in blended families, the survivor does not need to be a beneficiary or the sole beneficiary of the bypass trust, thus allowing the first deceased spouse to leave property directly to children who are not the children of the survivor. Second, the bypass trust may permit discretionary income distributions to the survivor, rather than mandatory income distributions, which are required in an A/C or Clayton QTIP structure, discussed below. Last, clients with highly appreciating assets who believe estate tax exposure is a risk may prefer using a bypass trust to remove those assets from their estates.

A/C Trust

Rather than a traditional A/B trust structure, many clients who do not believe they will have a taxable estate may benefit from an A/C trust structure. The C trust would be structured to qualify as a QTIP Trust for federal estate tax purposes, meaning (i) the surviving spouse would be entitled to all trust income at least annually, (ii) only distributions of principal may be made to the survivor, and (iii) no party may appoint the trust property to anyone other than the survivor during the survivor's lifetime. *See* Treas. Reg. § 20.2056(b)-7(d). The deceased spouse's executor (for federal estate tax purposes) would file a federal estate tax return to make a portability election, a QTIP election, and a "reverse" QTIP election. Each is discussed below.

There is no question that an A/C trust structure is less flexible than a simple revocable trust. An A/C trust functions similarly to an A/B trust. In the case of a joint trust, at the death of the first spouse, the trust property is divided between the two trusts. In the case of separate trusts, all of the trust property of the deceased spouse's trust is contributed to the C trust. The division, if any, is a requirement, not a mere suggestion. If the survivor is the trustee and does not fund the C trust, such failure can expose the survivor to liability to C trust beneficiaries who are harmed. To make a QTIP election, the deceased spouse's executor must file a federal estate tax return *even if* the deceased spouse's estate is below the federal estate tax basic exclusion amount. Prior concerns that an unnecessary QTIP election may be rejected were ameliorated in Rev. Proc. 2016-49, in which the IRS confirmed that a QTIP election made to elect portability would be respected. Thus, an A/C trust commits the executor to filing the federal estate tax return for both portability and QTIP election purposes.

Because of the QTIP Trust rules, in a purely A/C trust, no changes can be made to the requirement that the survivor receive all income at least annually from the C trust. Although the executor could fail to elect QTIP Trust treatment for part or all of the C trust, that would not, absent a Clayton provision, alter the QTIP Trust requirements in the trust instrument.

The ability to elect portability coupled with the GST Tax benefits and income tax savings of the C trust make the A/C trust structure very compelling for clients with moderate wealth. Unlike the nine-month fuse on a qualified disclaimer, a QTIP election is made on a timely-filed federal estate tax return. The return is due nine months after the deceased spouse's death, with an automatic six-month extension to file if timely requested. *See* Treas. Reg. §§ 20.6018-1(d), 20.6075-1, 20.6081-1(b). Thus, the A/C trust structure grants an additional six months to make decisions about the outcome of the trust after the first death.

The executor is also permitted to make a partial QTIP election, effectively splitting the C trust into two parts—the qualified and nonqualified portions for QTIP Trust purposes. *See id.* §§ 20.2056(b)-7(b)(2) (i) & (ii), 20.2056(b)-7(d)(3). The principal interest of any portion of the C trust, however, can retain creditor protection from the survivor's creditors. At the survivor's death, all of the assets in the QTIP

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trust are included in the survivor's estate for federal estate tax purposes. *See* I.R.C. § 2044. Though this exposes those assets to federal estate tax at that time, it also permits the non-IRD assets in the C trust to have an income tax basis adjustment at the second death without requiring the use of a general power of appointment. *See id.* § 1014(b).

Although the GST Tax exemption of the deceased spouse cannot be included in a portability election, it can be preserved up to the value of the C trust through a "reverse" QTIP election. *See id.* § 2652(a)(3). The election treats the trust property as though it were most recently included in the deceased spouse's estate for federal estate tax purposes, notwithstanding I.R.C. § 2044, thus allowing the deceased spouse's executor to allocate the deceased spouse's GST Tax exemption to the C trust. This effectively preserves the deceased spouse's GST Tax exemption in the same way it could be preserved by allocating it to the bypass trust in a traditional A/B trust structure.

The surviving spouse of a QTIP Trust may have a limited power of appointment, but not a general power of appointment. *See, e.g.,* Treas. Reg. § 20.2056(b)-7(b)(2)(i) (a QTIP election may be made for property qualifying under I.R.C. § 2056(b)(7)(b)(i), but a trust granting a general power of appointment qualifies under I.R.C. § 2056(b)(5)). The class of permitted appointees can be broad, exclusive of only the survivor, the survivor's estate, the survivor's creditors, or the creditors of the survivor's estate. *See* I.R.C. §§ 2041(b), 2056(b)(5). Alternatively, the class of permitted appointees could be limited as much as the spouses decide, which is often to the exclusion of individuals who are not descendants of the spouses or their parents. If a client desires to expand the class to include anyone or any entity, that could be accomplished without losing limited power of appointment status if the power is limited to an ascertainable standard or can only be exercised in conjunction with another person. *See id.* § 2041(b)(1).

Clayton QTIP Trust

Although the Clayton QTIP Trust is similar to the A/C trust structure, it has one important distinction: the ability to elect to use a bypass trust. In effect, the Clayton QTIP Trust structure combines the flexibility of a disclaimer bypass trust with the tax-favorable structuring of an A/C trust. As basic estate planning documents go, it is the authors' preferred structure for clients with at least \$3,000,000 of wealth per spouse. The Clayton QTIP Trust name comes from a titular 1992 Fifth Circuit decision in which the Court reversed the U.S. Tax Court and concluded that a partial QTIP election that could cause the unelected portion to be added to a bypass trust did qualify for QTIP Trust treatment. *See Clayton v. Comm'r*, 976 F.2d 1486, 1497 (5th Cir. 1992). Effectively, the date of the QTIP election relates back to the date of death, thus creating the mechanism to provide that the unelected portion of the C trust could be held in a bypass trust that *does not* qualify for QTIP treatment. *See Rapp v. Comm'r*, 140 F.3d 1211, 1218 (9th Cir. 1998). The Treasury Regulations now include a Clayton-inspired example that concludes that a Clayton QTIP election resulting in the unelected portion of the property passing to the decedent's children would not disqualify the QTIP Trust for the federal estate tax marital deduction. *See* Treas. Reg. § 20.2056(b)-7(h), ex. 6.

The downsides to a Clayton QTIP Trust structure are mostly similar to those of an A/C trust structure. One additional downside is that the survivor should not have the ability to make the QTIP election. Ideally, the person empowered to make the QTIP election would be an independent party (not related or subordinate to the survivor under I.R.C. § 672(c)). Without this insulation, the survivor could be viewed as making a gift of the unelected property, and, in any case, the trustee is subject to fiduciary duties that could be tricky for the survivor to exercise without implicating conflicts of interest.

If there is concern that the remainder beneficiaries might complain about the election, it may be preferable to waive fiduciary liability to the extent possible, at least as it relates to making the QTIP election. *See*

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U.T.C. § 1008. The QTIP election could generate differing legal rights in different beneficiaries, depending on the disparity in the terms of the QTIP Trust and the bypass trust, thus placing an unprotected trustee in an unenviable situation.

The Clayton QTIP trust structure gives the maximum amount of flexibility to choose between permanent outcomes after the deceased spouse's death. Because the outcomes are tied to the QTIP election that will be made on a federal estate tax return, the important decisions about what trusts should be funded can be deferred for up to 15 months after the date of death. No other option gives this amount of tax and nontax flexibility.

A Clayton QTIP Trust may be the closest thing to a crystal ball. It is, of course, impossible to predict the future. Whether a Clayton QTIP Trust will continue to provide the most flexibility in the future is unknown. But, under current law, nothing approximates the flexibility it affords. The ability to defer making permanent decisions until up to 15 months after the date of death is incredibly valuable on several tax and nontax levels.

First, the apparently constant change in the federal transfer tax system merits, where possible, as much information as reasonable to do effective planning. The added buffer of a Clayton QTIP Trust does just that. The executor can gather 15 months of posthumous facts before committing to permanent tax outcomes. Nothing will be perfect, and there will always be uncertainty about the future beyond the 15 months, but having additional data will almost certainly lead to wiser decisions.

Second, the survivor's circumstances may be clearer based on facts gathered during the 15 months after the deceased spouse's death. If the tax laws do not appear to be at risk of detrimental change and the survivor is in poor health, then the QTIP election may be more attractive than if the tax laws have or appear to be headed toward a change that would increase the tax liability at the second death. Having flexibility to pick the outcome under these circumstances is very handy.

Third, assets are also not necessarily static in nature. Over time, their values can change and circumstances relating to the assets can change, in ways that improve or impede their desirability. Whether an asset is increasing in value might not be apparent on the deceased spouse's date of death. Additional information in the interim might make that trajectory apparent and thus relevant to the desirability of having a bypass trust.

Finally, the survivor can accept the benefits of the property over which a QTIP election is not made, assuming the survivor is a bypass trust beneficiary. Unlike in a disclaimer bypass situation, when the survivor is a beneficiary of all of the trusts, there is no concern that distributing income to the survivor might disqualify the trust to do what was intended by the bypass trust mechanism.

Conclusion

As noted in the beginning of this article, the basic structure of any estate plan should include a revocable trust. In addition to offering a more streamlined administration upon the settlor's death, use of a revocable trust can offer significant benefits with respect to the management of finances during the individual's life. These advantages are particularly relevant in the event of incapacity, as the trust provides freedom from burdensome proceedings such as a conservatorship or guardianship of the estate.

Given the frequent changes in laws and client circumstances, most plans would benefit from additional flexibility. Under these circumstances, that usually means using a simple revocable trust, an A/C trust, or a Clayton QTIP Trust structure. In deciding which structure is most suitable, clients and practitioners must

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consider not only the wealth of the individuals but also the potential value of preserving flexibility within the estate plan in order to account for changes in the tax law, family circumstances and dynamics, and the value of the estate itself.