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Articles
Trust and Estate Law
Joint Revocable Living Trusts: the Good, the Bad, and the Ugly
by Miriam (Mimi) Abrams Goodman

Trust and Estate Law articles are sponsored by the CBA Trust and Estate Section. Topics include trust and estate planning and administration, probate litigation, guardianships and conservatorships, and tax planning.

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This article suggests ways for Colorado practitioners to amend and administer joint revocable living trusts for clients who move to Colorado from community property states, where these trusts are common.

A joint revocable living trust allows a married couple to create (settle) two revocable living trusts within one document. Revocable living trusts are widely used by estate planning attorneys to remove clients' assets from probate administration. The joint revocable trust performs this function and also provides a logical receptacle for titling spouses' community property in community property states.

Colorado is neither a community property state nor one where estate planning is driven by the avoidance of probate; however, some firms here use the joint revocable trust as a standard estate planning instrument. Clients are bringing funded joint revocable trusts to Colorado as they migrate here from community property states. Therefore, Colorado trust and estate attorneys are likely to represent estate planning clients who already have a joint revocable trust in place, or fiduciary clients who need to administer a joint revocable trust.[1]

This article is primarily directed toward practitioners who do not use the joint revocable trust in practice but are faced with estate planning clients who have a long-standing attachment to an existing joint revocable trust or a need to continue using such a trust to maintain community property in Colorado. First, this article provides a checklist to help the practitioner assess whether existing joint revocable trusts will produce "good" or "bad" gift and estate tax results for clients with a taxable estate; in particular, whether the trust is properly structured to accomplish conventional marital deduction planning at the death of a spouse.[2] Next, the article provides some practical tips on administration of the trust when one spouse dies. Finally, the article explores the use of a joint revocable trust in connection with a pre-marital agreement in Colorado, to isolate property spouses intend to share during their marriage from the remainder of their estates and beneficiaries.

Many practitioners believe the joint revocable trust is too risky, complex, and hard to adapt for use in a common-law property state.[3] A bias against the joint revocable trust persists in Colorado and is partly the result of national commercialization of such forms, in some cases by companies that have engaged in the unauthorized practice of law. *See* the accompanying sidebar entitled "Terminating an 'Ugly' Trust."

Terminating an "Ugly" Trust—Practice Pointer
Last year, a surviving spouse came to the author's office with a joint revocable trust. It had been provided to the client and her deceased husband by their Colorado financial advisor, through an arrangement with a Nevada corporation operating out of Utah. The documents appointed the Nevada corporation as successor trustee of the part of the trust that became irrevocable after the death of the first spouse, with the Colorado financial advisor serving as "trust officer."

When the husband died, the trust, which contained numerous ambiguities and errors, could not be amended or replaced. Although the trust was unfunded before the husband's death, it was necessary to probate the husband's pour-over will packaged with the trust to avoid intestacy.

Fortunately, it was possible to work with the surviving spouse and remainder beneficiaries to remove and replace the self-appointing successor trustee and terminate the trust. The financial advisor, still in business, informed the author that there had been a "blanket amendment" to the trust to the effect that the Nevada corporation was now trustee and trust officer, due to the Colorado financial advisor's conflict of interest. The Nevada corporation did not object to the beneficiaries' letter of termination, even though the trust document required "just cause" for removal.

The lesson: Colorado's Office of Attorney Regulation Counsel and other state regulators endeavor to shut down these operations; however: (1) we do not know the extent to which the landscape is littered with their executed documents and (2) our administrative skills will be challenged to implement the decedent's goals and intentions within their provisions.

Still, a growing number of Colorado estate planning attorneys are investing in sophisticated national form packages that include the joint revocable trust as a drafting choice.[4] Clients moving to Colorado from community property states, where use of the joint revocable trust is common, are typically advised by their home-state attorney to consult a Colorado estate planning attorney before taking title to their new Colorado home. Due to the unknown number of executed "ugly" joint revocable trusts lying in wait for their settlor's death, the increasing use of joint revocable trusts by Colorado attorneys, their widespread use in states from which many new Colorado residents originate, and the ability to protect clients' community property under Colorado's Uniform Disposition of Community Property Rights at Death Act (Act),[5] acquiring skill in amending and administering joint revocable trusts is necessary for Colorado trust and estate attorneys.

Joint Revocable Trusts and Community Property

The Act allows new Colorado residents to maintain the character of community property they bring to Colorado and continue that character in the Colorado property they acquire in exchange for community property. The Act provides little guidance for perfecting title to community property in Colorado, requiring the surviving spouse to present a written demand against the deceased spouse's estate and obtain a court order.[6] Some practitioners recite community property language on a Colorado real property deed, such as "to Husband and Wife as their community property." This language preserves a basic feature of community property—that is, the retention of testamentary control over one-half of the property by each spouse.

Colorado's real property laws provide that:

> Any conveyance or devise of real property to two or more persons that does not create or is not presumed to create an estate in joint tenancy . . . shall be a conveyance or devise in tenancy in common or to tenants in common.[7]

Including community property language on the deed should rebut any presumption that the resulting tenancy in common is a severance of the community property.[8] However, the tenants-in-common approach will not work in every situation.[9]

If clients already have a joint revocable living trust, it can be an excellent vehicle for maintaining the character of their community property in Colorado. The principal advantage is to secure the step-up in basis under IRC § 1014(b)(6)[10] for both halves of the property at the first death, instead of just the half of the deceased spouse. For a wealthy retired couple, even in this recessionary economy, there still may be substantial gain built into the community property assets brought to Colorado. The attorney should perform the necessary maintenance on the clients' existing joint revocable trust to allow the clients to continue to title their real and personal community property in the trust. The aim of this maintenance is to ensure that the trust will not encounter administration problems under Colorado law and will accomplish the clients' federal estate and income tax purposes.

Amending a Joint Revocable Trust

In addition to client updates and general attorney revisions made to estate planning instruments, the clients' existing joint revocable trust should be carefully reviewed with respect to the issues discussed below. If possible, the attorney should schedule a phone conference with the drafting attorney in the community property state to discuss any provisions of the trust that need clarification.

Identifying and Scheduling Trust Property

An effective way to add value to the joint revocable trust is to prepare or update a schedule of trust property and make sure each asset is identified as separate property or community property.[11] Any marital property agreement included in the clients' existing estate planning documents should be carefully reviewed. The joint trust agreement should define the various types of property the spouses may contribute to the trust and provide a presumption or default rule if a trust asset is not specifically identified as separate or community property.

Typically, trust language will direct that the character of community property does not change when it is contributed to or withdrawn from the trust. Under these provisions, withdrawals by or distributions to either spouse of community property are deemed to retain their character as community property regardless of which spouse receives them, avoiding the need for any re-balancing of the community property account in the trust. The trust may have different rules of revocation and amendment for community property than for separate property, which also prevents any severance or other change in the community property nature of the assets.

If the clients intend to acquire new joint property in Colorado that is not community property or the proceeds of community property (for example, earnings), counsel may want to consider strategies for keeping such assets outside the joint revocable trust. Alternatively, the attorney may consider adding a provision to the trust that (1) defines additional types of joint property that may be contributed; (2) severs any rights of survivorship in such property; and (3) divides the joint property equally between the separate property accounts of each spouse at the time of contribution.[12]

Tracing Community Property

Sometimes, clients will have fully funded their joint revocable trust, and may have become so attached to it that the attorney feels compelled to maintain the trust even if there is no basis step-up advantage. If there is potential for such an advantage, the attorney will want to stress the importance of tracing the community property going forward. A realistic record-keeping procedure should be established, considering the types of property the clients own and are likely to own, their age, their record-keeping habits, and the general transience of investments.

Avoiding Taxable Gifts on Transfer of Property

If improperly drafted, the spouses' contributions to a joint revocable trust can unintentionally cause unfavorable gift and estate tax consequences.[13] To avoid completion of a gift on funding, the trust agreement should reserve in each spouse dominion and control over property contributed to the trust by reserving the contributing spouse's power to withdraw the property at any time, without the consent of the other spouse, trustee, or any other party.[14] This withdrawal power should apply not only to a spouse's separate property, but also to the spouse's share of community or joint property. Retaining the power of withdrawal will not prevent completion of a gift on transfer if exercise of the power requires joint action with the other spouse, because the other spouse has a substantial adverse interest in such a withdrawal.[15] If spousal consent is required for withdrawal, a contribution to the trust will not qualify for a gift tax marital deduction under IRC § 2523. The contributing spouse's retained ability to enjoy the property, if he or she is the surviving spouse, makes the transfer a terminable interest under IRC § 2523(b)(1), but it fails to qualify as terminable interest property under IRC § 2523(f)(2), because the donee spouse does not have an exclusive right to income from the property. The spouses' reserved powers of revocation and amendment also should be reviewed to ensure that neither spouse parts with dominion and control over property contributed to the trust under those provisions. For example, on revocation, each spouse should receive all property he or she contributed to the trust, not one-half of the trust property.

Limiting Estate Tax Inclusion

With a taxable estate, the trust agreement should provide clear rules for determining each spouse's beneficial interest in the trust, so it is clear at the first death which trust assets belong or do not belong in the deceased spouse's gross estate for federal estate tax purposes. This task is less intimidating than it appears when one considers that it is accomplished on a routine basis in community property states. The attorney should first ensure that each spouse's share of trust property is well defined, and that each spouse retains dominion and control over his or her share until the first death. Where the trust agreement addresses the first death of a spouse, there should be a clear definition of the deceased spouse's share of the trust before discussion of division and distribution of that share. The survivor's share also should be clearly defined. The deceased spouse's share should be irrevocable after the first death to avoid inclusion of those assets in the surviving spouse's taxable estate.

Avoiding Taxable Gifts to Remainder Beneficiaries

The surviving spouse should retain power to amend, revoke, or withdraw the survivor's share after the first death, to avoid a taxable gift from the surviving spouse to the remainder beneficiaries of the survivor's share. Provisions of the trust addressing payment of the deceased spouse's estate administration expenses, as well as taxes and claims against the deceased spouse's estate, should require those expenses to be paid from the deceased spouse's share of the trust to avoid a taxable gift from the surviving spouse to the remainder beneficiaries of the deceased spouse's share.

Protecting Against Creditors

A single revocable living trust document does not need to specifically authorize the trustee to pay the obligations of the creator (settlor) of the trust. Such provisions appear in the joint revocable trust for the purpose of clarifying from which settlor's share of the trust such obligations should be paid. The intent is to protect one settlor's share of the trust from the creditors of the other spouse. These provisions work in tandem with instructions to pay the deceased settlor's estate administration expenses, taxes, and claims against the deceased spouse's estate from the deceased settlor's share of the trust.

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Assuming the clients have changed their domicile to Colorado, and the trust will be administered in Colorado, a more cost-effective administration will result if the trust situs is changed to Colorado and Colorado law governs administration of the trust. The laws of the state where the community property originated should continue to govern issues relating to the community property, insofar as those issues cannot be resolved by the Act.

Administering a Joint Revocable Trust

Administration of a joint revocable trust at the death of the first spouse requires a few adjustments as compared to administration of a decedent's individual revocable trust. When preparing the estate and trust inventories, the attorney will need to update the tracking of community property. Each community property asset or debt, whether inside or outside the trust, is scheduled on the deceased spouse's federal estate tax return. This includes community property assets titled in the surviving spouse, such as the survivor's retirement accounts. The surviving spouse's share of the asset or debt is then subtracted from the scheduled value of the asset. The surviving spouse's separate property and share of joint property that is not community property, whether inside or outside the trust, is not included on the deceased spouse's estate tax return.

Dividing the joint revocable trust into its successor income tax payers at the first death can be complex. The accompanying sidebar entitled "Tax-Efficient Division of a Joint Revocable Trust" illustrates how a joint revocable trust holding a number of investment accounts can be divided and distributed to its beneficiaries within one fiscal year after the death of the first spouse, assuming there are no other problems causing delay.

Tax-Efficient Division of a Joint Revocable Trust*

While both spouses are living, their investment advisor manages a set of accounts titled "Jones Family Trust," typically identified with one spouse's social security number due to the revocable nature of the trust (JFT 01 accounts). When one spouse dies, these accounts should immediately be replaced with new accounts, with a new tax ID (JFT 02 accounts). The JFT 02 accounts are held during the period of post-death administration (until property values are finally determined for estate tax purposes) to enable division and distribution of the Jones Family Trust to its beneficiaries (Trust Beneficiaries); for example, a Credit Shelter Trust and a Marital Trust created from the deceased spouse's share, and a Survivor's Trust funded with the surviving spouse's share.

If the year of the deceased spouse's death is Year One, all Year One 1099 income from the JFT 01 and JFT 02 accounts can be allocated between two Year One income tax returns—the spouses' final joint 1040 and the Jones Family Trust's first and final 1041, which reports with a fiscal year ending on the last day of the month before the month of the decedent's death, as a § 645 electing trust (JFT 1041). Pre-death tax items from the JFT 01 accounts will be reported on the spouses' final 1040; post-death tax items from those accounts will be reported on the JFT 1041. Tax items from the JFT 02 accounts will be reported on the JFT 1041. Only one JFT 1041 should be required, as long as the joint trust can distribute all of its assets to the Trust Beneficiaries and terminate in calendar Year Two, before the end of its fiscal year.

The investment advisor should be prepared for the termination with another new account or set of accounts for each Trust Beneficiary. The Trust Beneficiaries will not receive any taxable income until Year Two, when each trust receives a Schedule K-1 reflecting terminating distributions from the Jones Family Trust, which begins the Trust Beneficiary's calendar year tax reporting schedule. Any residual tax items on Year Two 1099s for the JFT 02 accounts can be reported on the JFT 1041, as long as these accounts cease to earn income and are not used for operating expenses after the end of the fiscal year.

In this example, taxes on Year One income realized after the deceased spouse's death are deferred until Year Three, when the Trust Beneficiaries will pay taxes on that income, which was reported to them in Year Two—their first tax year. Between the administration expenses deducted on the JFT 1041 (assuming the fiduciary does not elect to take them on the 706) and terminating distributions to the Trust Beneficiaries, there is not likely to be any taxable income trapped in the Jones Family Trust.

Allocating the terminating distributions of the Jones Family Trust between the Trust Beneficiaries also can be complex. First, there is the basic task of determining the value of each Trust Beneficiary's share of the Jones Family Trust, which, depending on the terms of the trust and the interest being funded, could be based on values determined for federal estate tax purposes, values at date of funding, or a combination of the two. Then, income and expenses during administration must be properly allocated among the Trust Beneficiaries' shares, according to the types of assets and the allocation methods dictated by the governing instruments. The attorney should pay particular attention to allocation of administration expenses in the JFT 02 operating accounts, to avoid the appearance of commingling of the deceased spouse's share and the surviving spouse's share. However, this complexity is short-lived, because it ends as soon as the JFT 02 accounts are distributed to the Trust Beneficiaries, as early as possible in Year Two. Expenses of

administering the deceased spouse's estate can be paid thereafter from the operating account of the Credit Shelter Trust or Marital Trust, depending on which entity is properly charged with the deceased spouse's administration expenses.

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Synthesizing the Trust With a Marital Agreement

A client contemplating re-marriage may want a prenuptial agreement to protect the inheritance of children from a previous marriage from claims by a surviving spouse for statutory exemptions, allowances, or an elective share of the client's estate. The client may have in mind an agreement to provide a specific property settlement for the surviving spouse (Settlement Property) rather than considering a complete waiver. If the agreement contemplates a testamentary transfer, it is in the nature of a contract to will, and the agreed terms should be documented by a valid agreement under the Colorado Marital Agreement Act,[16] and implemented by wills or other testamentary documents referencing the parties' obligations.[17] In the absence of such implementation, the surviving spouse is burdened with asserting a contractual claim against the deceased spouse's estate, and may be subject to deadlines for presentation under the non-claim statute.[18] Integrating asset titles is equally important to avoid burdening the survivor with constructive trust or other litigation to enforce the marital agreement.

Settling a joint revocable trust in conjunction with a marital agreement and titling the Settlement Property in the joint revocable trust could be a useful estate planning tool in this situation. It could eliminate concerns that estate planning documents the spouses otherwise would be obligated to create are not created or properly executed, or do not correctly specify the terms of the marital agreement. It also could provide some protection for the surviving spouse, who could serve as sole successor trustee of the joint trust, at least while competent, and have management control over the Settlement Property. The surviving spouse would have to cooperate with the personal representative of the deceased spouse's estate for tax reporting purposes; however, removing the Settlement Property from the deceased's estate might reduce the friction that often exists between the surviving spouse and the deceased spouse's children.

Gift tax issues can arise in connection with a marital agreement that provides a property settlement to a spouse, depending on when a promised transfer is enforceable and when it is capable of valuation.[19] For example, a marital agreement to maintain title to property in a joint revocable trust, and not revoke or amend spousal bequests in the trust without the other spouse's consent, causes the loss of dominion and control otherwise preserved to each spouse in the drafting of the trust. The agreement becomes effective under Colorado law at marriage,[20] and is not revocable without the consent of the other spouse,[21] whose interests are substantially adverse to the contributing spouse's power to withdraw. If this constitutes a completed transfer for gift tax purposes, the other spouse's release of marital rights under the marital agreement would not be considered adequate and full consideration under the gift tax regulations.[22] The transfers also would fail to qualify for the unlimited gift tax marital deduction.

As long as the marital agreement and the joint revocable trust do not obligate either spouse to make a lifetime transfer to the other spouse—and any interest granted to the other spouse or the trust remainder beneficiaries remains completely executory, unenforceable, and incapable of valuation until the death of the first spouse—the combination of the marital agreement with the joint revocable trust should not be deemed a complete transfer until the death of the first spouse. Spouses who are party to such a marital agreement should reserve the unlimited lifetime power to consume property contributed to the joint revocable trust for their own benefit, preventing valuation or completion of any gift until death.[23] The obligation under the marital agreement to transfer property at death is subject to the condition of the marriage lasting until that time, which cannot be determined until the first death.[24] If a spouse also retains the right under the agreement and trust to change the beneficiaries who enjoy the spouse's share of the trust after the death of the surviving spouse, the transfers also are incomplete under Treas. Reg. § 25.2511-2(b).

The deceased spouse's remainder beneficiaries would have the same vested interests in Settlement Property owned by the joint revocable trust as they would have in a marital trust created under the deceased spouse's estate, or in property titled in the surviving spouse in fee simple, subject to a marital agreement.[25] The difference is that with the Settlement Property titled in a joint revocable trust, the surviving spouse will be in control of the property, will not be entangled with administration of the deceased spouse's estate, and will not face consequences of the deceased spouse's failure to leave the estate planning documents required by the marital agreement.

Conclusion

Although not typically used as an estate planning instrument in Colorado, the joint revocable trust is sometimes used in Colorado by estate planning attorneys who practice with national forms, and often migrates here from community property states. The joint revocable trust can be particularly useful to clients who want the income tax benefit of maintaining their community property after moving to Colorado. The Colorado trust and estate attorney should understand how these trusts operate to assist clients with trust amendments and administer the trust at the death of the first spouse. Beyond these basics, the attorney may identify a situation where a client contemplating re-marriage may appreciate the prospect of segregating marital property from the spouses' separate estates and beneficiaries, by titling the property in a joint revocable

trust pursuant to a premarital agreement.

Notes

1. This article is not intended as an introduction to joint revocable trusts or community property. *See* Johns *et al.*, *Colorado Estate Planning Handbook* (*Orange Book*), at chs. 22 (for discussion of community property) and 23 (for discussion of joint revocable trust) (5th ed., CLE in Colo., Inc., 2008 supp.).

2. An *Orange Book* form exists for use of a joint revocable trust with a nontaxable estate. *See Colorado Estate Planning Forms* (*Orange Book Forms*), (6th ed., CLE in Colo., Inc., 2009 supp.), Form 13B.

3. *See* Zaritsky, 860 T.M., *Revocable Inter Vivos Trusts* § VI.C (for discussion of these risks and complexities). *See also* Merck, "Joint Revocable Trusts for Married Couples Domiciled in Common-Law Property States 32 *Real Prop. Prob. & Tr. J.* 345 (Summer 1997), available at findarticles.com/p/articles/mi_qu3714/is_199707/ai_n8765415/.

4. For example, the WealthDocsx™ Document Drafting System. As of November 16, 2009, WealthCounsel®, a national membership-based organization supporting estate planning attorneys, had forty-six members in Colorado. The director of technology, Marlene Frith, estimates that 30 to 40 percent of members in separate property states occasionally use the joint revocable trust when they feel the circumstances warrant it.

5. Colorado Uniform Disposition of Community Property Rights at Death Act (Act), CRS §§ 15-20-101 to -111.

6. CRS §§ 15-20-105 and -106.

7. CRS § 38-31-101(4).

8. *See* Rev. Rul. 68-80, 1968-1 C.B. 348.

9. *See* Krohn, "Community Property Rights in Colorado Real Property," 27 *The Colorado Lawyer* 63 (April 1998) (discussing title issues where community property is concerned).

10. Under that section, property that receives new basis by virtue of being acquired from a decedent includes the surviving spouse's share of community property held by the decedent. In other words, community property gets 100 percent step-up, if not excluded under some other provision of the Internal Revenue Code (Code or IRC).

11. The Act does not recognize "quasi community property." Quasi community property is defined in community property states as "property acquired by a married couple while residing in a common law state that would have been community property if they had resided in a community property state." S*ee* Cal. Prob Code § 66. Because the spouses lose the rights to such property that were available to them under the laws of the common law state (that is, family allowance, exempt property, and elective share), the community property state may extend community property protections to such property in the event of divorce or death. Transmutation of such property into community property under the Act is beyond the scope of this article. *See* Johns *et al., supra* note 1 at 22-10 n.71.

12. The challenges of amending the trust to accommodate a new category of non-community joint trust property, or of creating a joint revocable trust from scratch for purposes of holding title to such property, are beyond the scope of this article.

13. *Supra* note 3 (discussed in the authorities cited).

14. *See* Treas. Reg. § 25.2511-2.

15. *See* Treas. Reg. § 25.2511-2(e).

16. CRS §§ 14-2-301 to -310.

17. CRS § 15-11-514.

18. *See* Johns *et al., supra* note 1 at § 5.6.2.

19. *See* Lischer, *Gifts*, 845-2d T.M. §§ V.A., IV.B.2.a, IV.B.2.e, and IV.A.3 (Bureau of National Affairs, Inc., 2009). *See also Hambleton v. Comm'r*, 60 T.C. 558 (1973).

20. CRS § 14-2-305.

21. CRS § 14-2-306.

22. Treas. Reg. § 25.2512-8.

23. *See* Treas. Reg. § 25.2511-2(b).

24. *See* Lischer, *supra* note 19 at § IV.B.2.a. *See also* Rev. Rul. 69-347, 1969-1 C.B. 227; Rev. Rul. 79-384, 1979-2 C.B. 344.

25. *See Tarr v. Hicks*, 393 P.2d 557 (Colo. 1964).

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