TAX, PROCEDURAL AND ADMINISTRATION RULES: CONTRASTING REVOCABLE TRUSTS WITH ESTATES

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I. INTRODUCTION

Revocable trusts have become one of the fundamental tools for estate planners. Many practitioners believe that every estate plan should include at least one revocable trust, regardless of the size or composition of the client's estate. They argue (often erroneously) that revocable trusts avoid the time and expense of probating a decedent's will, and that they provide a good vehicle for management of the settlor's assets in case of disability, while posing no substantial tax risks. For many estate planning clients, a revocable trust is a good tool for assuring competent management of assets in case of disability and the disposition of assets at death. A revocable trust will, however, provide no significant advantages for some clients over a properly drawn will and a durable power of attorney. At the same time, in some situations, the use of a revocable trust may create significant potential problems in drafting and administration, both during the client's lifetime and after the client's death. In addition, a revocable trust may raise serious tax and nontax problems for a few clients. This outline is intended to review some of the unique issues, both during a client's lifetime and after the client's death, that arise from the use of a revocable trust as a primary estate planning tool.

II. CUSTOMARY USES AND BENEFITS OF REVOCABLE TRUSTS

A. Probate Avoidance—The Funded Revocable Trust as Will Substitute. There are several situations in which a funded revocable trust may be an appropriate will substitute.

1. Avoiding Judicial Super-vision. A revocable trust may be an appropriate will substitute for a client who wishes to avoid the judicial supervision of the administration of the client's estate that is otherwise required in many jurisdictions. A decedent's property held in a revocable trust is not part of the decedent's probate estate, and, therefore, is not subject to the administrative procedures affecting probate property. In some jurisdictions (California and South Carolina, for example) attorney fees in probate matters are based in large measure on the size of the probate estate. *See* CAL. PROB. CODE § 10810; SC CODE § 8-21-770While no such rule exists in Texas, some clients become committed to avoiding probate because they have heard, either second-hand or from the living trust marketing "machine," that probate is a long and expensive process. In many states, the truth is that "probate" itself is rather straight-forward, even if the overall administration process (gathering assets, dealing with creditors, filing tax returns, resolving disputes among heirs, funding bequests, etc.) may be complex. While a funded revocable trust may avoid probate court supervision, it does not avoid the balance of the administration process. Nevertheless, to the indoctrinated, there is often little that can be done to assuage these fears, and a revocable trust can be a particularly useful tool for avoiding probate.

2. Post-Probate Supervision of Testamentary Trusts. One reason to avoid probate is that many states have burdensome post-probate court supervision of testamentary trusts. In some states, for example, the trustees of testamentary trusts must file annual accountings with the local courts or with designated officials of the courts, while the trustees of trusts created upon the death of a settlor of a revocable trust–even those funded by pour-overs of settlors' estates–need not file accountings. *See Will of Reed*, 91 Misc. 2d 997, 399 N.Y.S.2d 101 (N.Y. Sur. Ct. 1977) (New York surrogates courts have jurisdiction over funded revocable trusts when the terms of the trusts intimately concern the "affairs of decedents"). Clients who own assets for which accountings may be quite difficult, such as unincorporated businesses, also have reason to avoid probate in these jurisdictions. In this situation, placing the business interest in a revocable trust, with or without other assets, may be advisable.

B. Out-of-State Real Estate. A client may also want to use a revocable trust if he or she owns real property in more than one state. Real property owned in another state will be subject to ancillary estate administration, which may be an expensive and cumbersome prospect. Ancillary administration may be avoided by having the assets held outside of the domiciliary state in a funded revocable trust. Similarly, while a revocable trust will not generally avoid the imposition of inheritance taxes in the jurisdiction in which the real property is located, by placing real estate and other assets held outside the state of domicile in a revocable trust, the settlor minimizes the risk that more than one state will attempt to treat the settlor as a domiciliary and, therefore, seek to impose multiple inheritance taxes upon all of the settlor's assets.

C. Ease of Continuation of Management. For a client that may have early signs of incapacity or may just decide that he or she would rather have someone else manage their financial affairs, a revocable trust can provide an effective management vehicle. In the case of incapacity, a funded revocable trust can avoid the expense, hassle and court supervision of a guardianship. If the client initially serves as the trustee of the trust, he can then provide for one or more successor trustees to take over when the time comes. Financial institutions seem to have fewer problems with dealing with a trustee of a trust for someone else's benefit than dealing with an agent for someone else pursuant to a durable power of attorney.

D. Mineral Interests. Clients who hold extensive mineral interests, even when they are all within the same state, may be well advised to transfer those interests into a revocable trust. When minerals are extracted, purchasers of the minerals have an economic incentive to hold royalty and other payments in suspense rather than make the payments. Accordingly, if there is any plausible basis for placing such payments in escrow (e.g., because title is unclear as a result of pending probate proceedings), the decedent's beneficiaries may face delays in receiving royalty and similar payments.

E. Privacy Concerns. A revocable trust may enable a client to avoid the publicity associated with probate. Revocable trust terms are not automatically made part of the public record, as wills are after the testator's death. *See, e.g.,* TEX. PROB. CODE § 81. In this regard, a revocable trust may be desirable for a client who prizes his or her privacy and wishes to preserve it even after death. On the other hand, many clients find that funding a revocable trust requires immediate disclosure. Most financial institutions, title companies, and other third parties wish to see (and often retain or record) a copy of the trust agreement as a part of the funding process. This disclosure can sometimes be avoided by providing a "certification of trust", which outlines only the identity and powers of the trustee, but not the dispositive terms. *See, e.g.,* TEX PROP. CODE § 114.086. In many jurisdictions, estates that go through probate must also file an inventory of estate assets in the public record. *See, e.g.,* TEX. PROB. CODE § 250(a), although this requirement is being relaxed in some cases (*See* TEX. PROB. CODE § 250(c), permitting the filing of an affidavit in lieu of inventory for many decedents dying on or after September 1, 2011). A client may feel particularly concerned that the dispositive terms of his or her estate plan remain private if the disposition is unconventional or may be potentially embarrassing to some family members (e.g., when provision is made for illegitimate children or paramours) or may be concerned that publicity will create "gold-digging" suitors for the surviving spouse or children. Even in today's more tolerant environment, a revocable trust is often particularly appropriate for a gay, lesbian, or nontraditional client. The lack of publicity and relative difficulty of challenging a revocable trust may minimize interference from biological relatives in the affairs of the deceased settlor's partner. *See* Chase, *Tax Planning for Same-Sex Couples*, 72 DENVER U. L. REV. 359, 398-399 (1995); Dubois, *Legal Planning for Gay, Lesbian, and Non-Traditional Elders*, 63 ALABAMA. L. REV. 263, 322-323 (1999).

F. Dealing with Neuroses. A client who has a deep fear of writing a will or planning their affairs in association with dying may be willing to prepare a "living trust" that will function as a will substitute. The difference in terminology and the non-testamentary "feel" to the revocable trust may enable the individual to execute a document with testamentary attributes. *See* Schlesinger, *Seven Case Histories of the Revocable Trust*, 5 U. MIAMI EST. PLAN. INST. § 71.1601 (1971).

III. SPECIAL CONCERNS FOR REVOCABLE TRUSTS—PRE-DEATH

A. Federal Deposit Insurance. The Federal Deposit Insurance Act, 243 12 U.S.C. §§ 1811—1835, provides for insurance of depository accounts in federal banks, up to the standard maximum deposit insurance amount (SMDIA) for each depositor. Revocable trust accounts represent one of the eight account ownership categories for which the Federal Deposit Insurance Corporation (FDIC) provides separate insurance coverage. For many years, the SMDIA was set at $100,000 per account. The Emergency Economic Stabilization Act of 2008, P.L. 110-343, temporarily increased the SMDIA for most depository accounts to $250,000. The SMDIA cap of $250,000 was then made permanent by the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203. Furthermore, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, P.L. 111-203, provides that all noninterest bearing accounts are fully insured through December 31, 2012.

1. The Final Regulations. In September 2009, the FDIC adopted final regulations intended to make the coverage rules for revocable trust accounts easier to understand and apply. The general rule limits coverage to an amount equal to the total number of "beneficiaries" multiplied by the SMDIA. 12 CFR § 330.10(a). An exception provides for a modified coverage limitation in cases where the aggregate revocable trust balances exceed $1,250,000 (five times the SMDIA) and more than five different beneficiaries have been named. 12 CFR § 330.10(e).

a. The General Rule. According to the regulations, "[T]he funds owned by an individual and deposited into one or more accounts with respect to which the owner evidences an intention that upon his or her death the funds shall belong to one or more beneficiaries shall be separately insured . . . in an amount equal to the total number of different beneficiaries named in the account(s) multiplied by the SMDIA."

b. Formal and Informal "Trusts." The general rule applies both to "informal" and "formal" revocable trust accounts. Informal trusts include payable-on-death (POD) accounts, in-trust-for accounts and so-called "Totten" trust accounts. Formal trusts include revocable trusts. 12 CFR § 330.10(a); *See also* Shaw, *Get More Bang for Your Buck - Or How to Maximize FDIC Deposit Insurance Coverage*, 33 TAX MGMT. EST., GIFTS & TR. J. 240 (Nov./Dec. 2008).

c. Beneficiaries of Multiple Accounts. Examples in the regulations clarify that naming the same beneficiary in more than one revocable trust account, (whether it be "informal" like a POD account, or a formal revocable trust account), does not increase the total coverage amount. All funds that a depositor holds in both informal and formal revocable trust accounts at the same FDIC-insured institution and name the same beneficiaries are aggregated for insurance purposes and insured to the applicable coverage limits. 12 CFR § 330.10(a).

2. Required Intention and Naming of Beneficiaries. As with all bank accounts, care must be taken so that the beneficiaries and amounts that pass from these accounts at death are coordinated with the rest of the client's estate planning. The intent that an account pass to beneficiaries at death, as set out in the general rule, "must be manifested in the 'title' of the account using commonly accepted terms such as, but not limited to, 'in trust for,' 'as trustee for,' 'payable-on-death-to,' or any acronym therefore." 12 CFR § 330.10(b)(1). For informal revocable trust accounts, the regulations provide that the beneficiaries must be specifically named in the deposit account records of the insured depository institution. 12 CFR § 330.10(b)(2). For formal trust accounts, however, the beneficiaries "must be identified in the trust's governing document but need not be named in the bank's deposit records, although the FDIC 'encourages' bank customers to do so." Shaw, "Get More Bang for Your Buck - Or How to Maximize FDIC Deposit Insurance Coverage," 33 TAX MGMT. EST., GIFTS & TR. J. 240 (Nov./Dec. 2008) (citing FDIC Financial Institution Letters (FIL-99-2008, revised as of October 8, 2008), available at http://www.fdic.gov/news/news/financial/2008/fil08099.pdf). "Title" under the regulations includes the electronic deposit account records of the institution. 12 CFR § 330.10(b)(1). As a result, the FDIC now recognizes an account as a revocable trust account even if the title of the account signature card does not expressly say so, as long as the institution's electronic deposit account records identify (through a code or otherwise) the account as a revocable trust.

3. "Beneficiaries." The term "beneficiary" is defined to include natural persons, charitable organizations, and other nonprofit entities recognized as such under the regulations. 12 CFR § 330.10(c). If a named beneficiary does not meet that definition, the funds corresponding to that beneficiary are treated as the owner's individually owned funds and are aggregated with any other single ownership accounts of such owner and insured up to the SMDIA. 12 CFR § 330.10(d).

4. Five-Beneficiary Rule. Section 330.10(e) of the deposit insurance regulations provides that for funds owned by an individual in one or more revocable trust accounts naming more than five different beneficiaries and whose aggregate balance is more than five times the SMDIA, the maximum revocable trust account coverage for the account owner is the greater of either: five times the SMDIA or the aggregate amount of the interests of each different beneficiary named in the trusts, to a limit of the SMDIA per different beneficiary. 12 CFR § 330.10(e). Note that the rules are more complex than simply multiplying the number of beneficiaries times $250,000. Three examples help to illustrate these rules. A has a revocable trust account with a balance of $1 million that names two of his children, W and X, as beneficiaries. At the same FDIC-insured institution, X has a POD account with a balance of $1 million naming two other children, Y and Z as beneficiaries. Since A names four different beneficiaries, A is insured in the amount of $1 million (determined by multiplying the SMDIA by four, the number of named beneficiaries), and uninsured for the remaining $1 million. B establishes a revocable trust account with a balance of $1,400,000. At B's death, the trust is payable to each of B's seven children in equal shares. Since the account is more than $1,250,000, the special rule applies, but each beneficiary is entitled to $200,000 upon B's death, so the account is insured for $200,000 per beneficiary or $1,400,000. Finally, C has a revocable trust account with a balance of $1,500,000, which provides that upon C's death, C's three children are each entitled to $125,000, C's friend is entitled to $15,000, and a designated charity is entitled to $175,000. The trust also provides that the remainder of the trust assets shall belong to C's spouse. In this case, because the balance of the account exceeds $1,250,000 (five times the SMDIA) and there are more than five different beneficiaries named in the trust, the exception applies and the maximum coverage available to C is the greater of: $1,250,000 or the aggregate of each different beneficiary's interest to a limit of $250,000 per beneficiary. The beneficial interests in the trust for purposes of determining coverage are: $125,000 for each of the children (totaling $375,000), $15,000 for the friend, $175,000 for the charity, and $250,000 for the spouse (because the spouse's $935,000 is subject to the $250,000 per-beneficiary limitation). The aggregate beneficial interests total $815,000. C is insured in the amount of $1,250,000, the greater of $1,250,000 or $815,000.

5. Co-Owned Revocable Trust Accounts. Where a revocable trust account is established by more than one owner, the respective interests of each account owner are deemed equal, unless otherwise stated in the insured depository institution's deposit account records, and are insured separately, per different beneficiary, up to the SMDIA, subject to the five beneficiary exception noted above. 12 CFR § 330.10(f)(1). However, a joint revocable trust account created by a married couple in which the spouses are named as the sole beneficiaries of the trust is treated as a joint account and is not treated as a revocable trust account. 12 CFR § 330.10(f)(2). As a result, the interests of each co-owner spouse in a joint account are added together, and the total is insured up to $250,000 per owner.

B. Title Insurance Issues.

1. Limitations of Coverage. Transfer of real estate into a revocable trust may result in loss of owners' title insurance coverage. The trust may be treated as an entity, separate and distinct from the transferor. The policy and relevant state law must be reviewed to determine any effects on the policy. For example, in *Covalt v. First American Title Insurance Co.*, No. 95-CV-1044-B (D. Wyo. 1996), a Colorado domiciliary purchased ranch land in Wyoming. An owners' title insurance policy was obtained. It contained no exclusions relating to access. After holding title to the property in his own name for some time, the owner, shortly before his death, conveyed the ranch by quitclaim deed into his revocable trust. The lower court held that "[t]he plain language of the policy limits coverage to the [individual purchaser] and to his heirs, devisees, and personal representatives. The [purchaser's] trust is not [such a person - not an heir, devisee nor personal representative] thus the [title] policy does not cover the transfer of the property into the former insured's revocable trust." The Tenth Circuit upheld the conclusions of the District Court, noting that "The policy clearly and unambiguously limited coverage to Maytag and his heirs, devisees, and personal representatives, which, according to Wyoming law, did not include the Maytag Trust." 105 F.3d 669, (10th Cir. 1997), an unpublished Order And Judgment (which is not binding precedent, except under the doctrines of law of the case, res judicata, and collateral estoppel, and may not be cited except under the terms and conditions of Tenth Circuit Court Rule 36.3).

2. Changes in Title Insurance Coverage. For title insurance, Texas requires the use of forms promulgated by the State Board of Insurance. Virtually every other state allows the use of forms adopted by the American Land Title Association (ALTA). In October 1998, the ALTA addressed the issue of the transfer of real estate and its effect on title insurance for future homeowners by adopting a new form policy for owners of one-to-four family residences. Its definitions and its "continuation of coverage" condition expressly extend this policy's coverage to the trustee and beneficiaries of a living trust to which the insured transfers the home after the policy date. The title insurer does retain the right to assert against the trustee or beneficiaries any defenses the insurer would have had against the insured settlor. The California Land Title Association added such coverage to its homeowner's policies earlier the same year. In 2001, the ALTA adopted an extended coverage residential loan policy to match its homeowner's policies. In Texas, new legislation was passed in 2009 so that for policies issued or renewed after January 1, 2010, continuation of coverage exists for residential real property transferred to a revocable trust. TEX. INS. CODE § 2703.101(g). Nevertheless, there are many potential problems with title policies and disputes still may arise regarding whether the policy covers (i) claims by the named insured after the insured has deeded the property into her revocable living trust and (ii) claims by a trustee or beneficiary of the trust. The important point is that when considering a transfer of real property to a revocable trust, the current title policy should be reviewed to determine if further action is required to maintain the policy coverage. CAVEAT: In evaluating these issues, the key factor is the date that the title policy was *issued*, and not the date that the real property was conveyed to the revocable trust. Also note that the changes outlined above apply to title policies for residential real property, and not commercial real estate.

3. Use of General Warranty Deeds. The issue might be addressed if the settlor of the revocable trust transfers to the trustee by general warranty deed, rather than the quitclaim deed sometimes used for intra-family transfers. Most title insurance policies provide that coverage continues so long as the insured has liability by reason of covenants of warranty made by the insured in any transfer or conveyance. As a result, upon discovering a title defect, the trustee could make a claim against the settlor, who could then make a claim against its title insurance policy. However, the policy will not indemnify for losses caused by defects, liens or encumbrances created *after* its original date, including any created in the transaction transferring title to the trustee; and recovery will be limited to the amount of insurance stated in the settlor's policy. Additionally, this technique will not be effective in states where recovery under warranty deed covenants is limited to the consideration the settlor received. Since the trustee pays no consideration for the estate planning transfer, the settlor would have no liability for damages and, thus, would have no loss recoverable under his title insurance policy. Further, if the settlor is deceased by the time the title defect is uncovered, as in the Wyoming case discussed above, the trustee has no one to sue. *See* Rivin and Stikker, *Title Insurance for Estate Planning Transfers*, PROB. & PROP (May/June 1998), p. 17. If a special warranty deed is used to transfer title, language should be included in the deed which transfers to the trustee of the revocable trust, the grantor's rights under any title policies. The best practice, although one which few client will be willing to pay for, is to obtain new title insurance when the real estate is conveyed to the revocable trust.

C. Joint Revocable Trusts. A common planning technique, especially in community property states, is for a married couple to create a single joint revocable trust, rather than two independent revocable trusts. Each spouse is a settlor of the joint revocable trust to the extent of his or her own contributions, and each is typically permitted to revoke the trust as to his or her contributions. Often, both spouses serve as co-trustees of the trust, sometimes together with a third trustee. Of course, there is no prohibition from a trust having multiple settlors and multiple persons may hold powers to revoke a trust. As will be seen from the following discussion, careful drafting of the trust agreement is needed to avoid potential problems. In addition, great care must be taken to delineate the rights of each spouse to revoke a joint revocable trust, both during the spouses' joint lives and after the death of the first spouse. The trust instrument should assure that each spouse has only the intended powers over the trust funds contributed by him or her and over the funds contributed by the other spouse. The special problems, both tax and nontax, raised by joint trusts have made them the subject of much debate.

1. "Separation Anxiety". One advantage of a joint revocable trust may be psychological. Many married couples believe that their assets, regardless of the peculiarities of title, are owned by both spouses together, in some form of perceived partnership. Such spouses may object to dividing their assets to fund two independent revocable trusts. This "separation anxiety" can sometimes be addressed by making both spouses co-trustees of each trust and funding each trust with an undivided one-half interest in each asset, but even this division of assets may be unacceptable to some spouses. On the other hand, a spouse who owns most of the marital assets in his or her own separate name may be wary of dividing those assets between two revocable trusts because the spouse believes that such a division increases the property rights of the other spouse in the case of a future divorce. *See* Heller, Ransford, & Stevens, *Joint Revocable Trusts*, 26 COLO. LAW. 63 (Aug. 1997). The use of a joint trust avoids the problem of separation anxiety.

2. Community Property. Joint revocable trusts may assist spouses in preserving the status of assets as community property under applicable state law. For example, in *In re Martin Est.*, 259 A.D.2d 809 (1999), a New York appeals court upheld a lower court determination that assets in the decedent's revocable trust were community property to which the surviving spouse was entitled to a one-half interest, because, in part, the trust instrument stated that the surviving spouse would receive one-half of the assets, and that it "plainly and unequivocally lists each of the contested items as community property." *Id.* at 811. While most revocable trusts don't list the assets held by the trust, language can be included to ensure that the marital property character of assets is not altered by contribution to the revocable trust. Maintaining the status of community property can both preserve marital and management rights afforded by state law, and achieve a step-up in basis for both shares of community property at the death of the first spouse. IRC § 1014(b)(6). Community property may be created by a married couple domiciled in Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin, and in certain foreign countries, such as Mexico. In Texas, community property can be further subdivided into each spouse's sole management or special community property, and the spouses' joint management or joint community property. Professor Thomas Featherston suggests a safe harbor approach whereby each spouse retains not only his or her right to revoke the trust as to his or her share of joint community property and his or her separate property but also as to his or her sole management community property after giving notice to the other spouse. Featherston, *Representing the Surviving Spouse: A Handbook for the Lawyer of the Decedent's Spouse*, 34th Annual State Bar of Texas Adv. Est. Planning and Prob. Course 2010.

3. Joinder of Both Spouses. Joinder of both spouses in the establishment and funding of the revocable trust is important to preserve the estate plan and avoid having the trust found to be illusory. In *Land v. Marshall*, 462 S.W.2d 841 (Tex. 1968), the husband formed a revocable trust and transferred the bulk of the community property estate which consisted of his sole management community property to a trust, without his wife's knowledge. The court found that the trust was valid, but as to the wife's share the trust was "illusory" and she was able to remove her share of the property from the trust.

4. Drafting Ease. Some practitioners believe that a joint revocable trust is simpler to draft and administer than two separate revocable trusts, because assets may be contributed in their present joint form rather than separated first and then contributed. This perceived advantage is only true for joint trusts that include careful drafting to account for each spouse's contributions. Without this drafting, serious adverse marital property and tax consequences can arise.

5. Implied Contract Not to Revoke. Joint revocable trusts may create a contractual problem. Some courts have construed joint wills as including an inherent agreement by the parties not to change the terms of their wills after the first spouse's death. *See* Annotation, *Establishment and Effect, after Death of One of the Makers of Joint, Mutual, or Reciprocal Will, of Agreement Not to Revoke Will*, 17 A.L.R. 4th 167 (1982). The same analysis may apply to a joint revocable trust. In *Alvarez v. Coleman*, 642 So. 2d 361 (Miss. 1994), spouses created a joint revocable trust and signed reciprocal pour-over wills. The trust stated that it would become irrevocable on the death of the first spouse to die, and provided for distribution to the wife's family and to a charity selected by husband after both spouses had died. The wife died, and the husband sought to revoke the trust and to make a new will leaving his property to members of his family. The Mississippi Supreme Court held that, taken together, the wills and the joint trust proved the existence of contractual wills, and invalidated the husband's purported revocation and subsequent testamentary disposition. The opposite result was reached in *Matter of West Est.*, 948 P.2d 351 (Utah 1997). There, the Utah Supreme Court found no contractual obligation for a surviving spouse not to revoke a joint revocable trust, in light of the express language of the trust instrument, which authorized the settlors, as joint trustees, to sell or otherwise dispose of the residence and thereby revoke the trust; and that, upon the first wife's death, the husband succeeded to all powers previously belonging to the couple as joint trustees, including the power to dispose of the residence. The implication of these cases is that, regardless of the ultimate outcome, the rules applied to reciprocal and mutual wills may apply with equal force to joint revocable trusts.

6. Incapacity of One Spouse. Joint revocable trusts may present special difficulties when one spouse becomes incapacitated. In particular, an issue arises as to whether an unimpaired spouse may unilaterally revoke the trust. If so, then the estate plan of the incapacitated spouse may be undone. If not, the unimpaired spouse may be tied to an estate plan that does not reflect current wishes and circumstances. Balancing these concerns can be problematic. One drafting approach, suggested by Wendy Farner and Diane Perrin of Houston, is to provide revocation language such as:

> While both of the Grantors are living, the Grantors acting jointly (or if one of them is incapacitated, then the remaining Grantor, acting alone) may by acknowledged instrument alter, amend, revoke or terminate this trust instrument on thirty days' notice to the Trustee (unless waived). No gift is intended by either spouse in executing this trust instrument. All property transferred to the Trustee to be administered pursuant to this trust instrument shall at all times (while held in trust or upon distribution from any trust to be administered pursuant to this trust instrument or upon revocation of this trust instrument) retain its character as community property or separate property under the marital property laws of the state of Texas or other applicable law. Upon any revocation of this trust during the Grantors' joint lives, community property shall be distributed to the Grantors (except if one of the Grantors is incapacitated, the Trustee may distribute, in its discretion, the incapacitated Grantor's undivided community property one-half interest to the incapacitated Grantor's attorney-in-fact or the legally-appointed guardian of his or her estate). Upon the death of the first Grantor to die, all provisions of this trust instrument shall become irrevocable, except that the surviving Grantor shall have the power to revoke the surviving Grantor's Management Trust.

7. Special Tax Problems of Joint Revocable Trusts. Joint revocable trusts create potential tax problems not typically present in transactions involving a revocable trust created by only one settlor. As stated above, careful drafting can avoid these problems.

a. Nondeductible Inter-spousal Gift on Creation of Trust. The transfer of property to a revocable trust is typically not a taxable gift, because the donor does not part with dominion and control over the transferred assets. Treas. Reg. § 25.2511-2.

(1) Avoiding the Gift Issue. A gift of property to a trust is, however, a taxable gift to the extent that the settlor does not reserve the right to reacquire ownership of the transferred asset. *See* Treas. Reg. § 25.2511-2(b). Thus, for example, a wife who contributes all of the property to a trust that she and her husband can each revoke is deemed to give her husband one-half of the trust assets if the revocation of the trust would result in distribution of one-half of the trust assets to each spouse. Such a deemed gift to a spouse does not qualify for the gift tax marital deduction if the trust terms give the donee spouse only a nondeductible terminable interest. A donee-spouse's interest in a revocable trust is a nondeductible terminable interest if the trust permits distributions during the surviving spouse's lifetime to someone other than the donee spouse or his or her estate. IRC § 2523(b). A nondeductible inter-spousal gift on creation of the trust can be avoided if each spouse retains the right to revoke the trust with respect to all separate property contributed to the trust by that spouse and to each spouse's share of all community property and property previously held jointly by the spouses. Neither spouse will have made a taxable gift in that case. *See Sanford's Est. v. Commissioner*, 308 U.S. 39 (1939); Merk, *Joint Revocable Trusts for Married Couples Domiciled in Common-Law Property States*, 32 REAL PROP. PROB. & TR. J. 345, 355 (Summer 1997).

(2) Accounting Issues. Reserving to each settlor a power to withdraw his or her separate contributions to the trust requires careful accounting for the various assets contributed to the trust. The assets need not be formally segregated by the contributor, but the trustees must maintain detailed records regarding which settlor contributed which asset. Failure to keep adequate records can result in a taxable gift on creation of the trust or inclusion of the entire trust fund in the estates of both spouses. As has been correctly noted: "The allocation of a couple's property between separate shares within a joint trust is tantamount to the creation of separate revocable trusts for each spouse. Consequently, the argument that a single joint trust document is less complex than separate revocable trust instruments is untenable." Merk, *Joint Revocable Trusts for Married Couples Domiciled in Common-Law Property States*, 32 REAL PROP. PROB. & TR. J. 345, 356-57 (Summer 1997).

b. Gift to Other Beneficiaries on Creation of Trust. A transfer to a revocable trust is not usually a completed gift, because the settlor's reserved right to reacquire the transferred assets renders the transfer incomplete. Treas. Reg. §§ 25.2511-1, -2; *see also* Adams & Abendroth, *The Joint Trust: Are You Saving Anything Other Than Paper?* 131 TR. & EST. 36, 41-42 (1992). However, a transfer of property to a trust that has beneficiaries other than the settlor may be a taxable gift. A reserved right to revoke a trust and reacquire the transferred assets does not render a gift incomplete if the power is exercisable only with the consent of a person who has a substantial interest in the trust that is adverse to the exercise of the settlor's power of revocation. Treas. Reg. § 25.2511-2(e). Therefore, a spouse's transfer of property to a joint trust in which both spouses have substantial beneficial interests, and that can be revoked only by the joint action of the spouses, may give rise to a completed taxable gift to the other trust beneficiaries upon the creation of the trust, since the spouses' interests are adverse. As between the spouses, the gift will likely not qualify for the gift tax marital deduction, because the trustee has the ability to distribute assets to the donor spouse, who is someone other than the donee spouse. IRC § 2523(b). Moreover, the amount of the gift may be the full value of the contributed property, without any reduction for the value of an income interest or a discretionary beneficial interest in trust principal, under § 2702. *See* Treas. Reg. § 25.2702-1(b). Again, if each spouse has the power to revoke his or her share without consent of the other spouse, the problem can be avoided.

c. Gift to Remainder and Other Beneficiaries at First Spouse's Death. A joint trust can also cause a completed gift by the surviving settlor to contingent or remainder beneficiaries of the trust upon the death of the other settlor. A completed gift to the contingent beneficiaries is deemed to occur on the death of the first spouse if: (1) the trust then becomes irrevocable; (2) future or current rights in the property contributed by the surviving spouse and over which he or she held a right of revocation become vested in or set aside for contingent beneficiaries; and (3) the surviving spouse no longer has the power to withdraw his or her own separate property contributed to the trust. Treas. Reg. § 25.2511-2(b). In this situation, the death of the first spouse causes the contributions by the surviving spouse to become completed gifts to the contingent beneficiaries. Moreover, as noted above, the amount of the gift may be the full value of the contributed property, without any reduction for the value of an income interest or a discretionary beneficial interest in trust principal, under § 2702. *See* Treas. Reg. § 25.2702-1(b). This problem may be avoided by preserving each spouse's right to revoke the trust as to his or her own contributions, and to reacquire those contributions, even after the first spouse's death. Such a power to revoke the trust as to each spouse's own contributions renders any potential gift by the surviving spouse incomplete for gift tax purposes. Of course, a power to revoke the trust after the first spouse's death may be inconsistent with the desired estate tax planning. A surviving spouse should not, for example, hold a power to revoke and acquire the assets of a non-marital trust created from the assets of the first spouse to die. In such situations, a gift to the remainder beneficiaries can be avoided if the surviving spouse retains a lifetime or testamentary special power to appoint the trust funds among a class of beneficiaries that does not include the surviving spouse, his or her estate, his or her creditors, or the creditors of his or her estate. *See* Treas. Reg. §§ 25.2511-2(b), (c).

d. Estate Taxation of Jointly-Owned Property Transferred to a Joint Revocable Trust. As discussed in more detail in Section VII. C. 7. below, § 2040(b) provides that only one-half of the value of property owned by a married couple, either jointly with a right of survivorship or as tenants by the entirety, is included in the estate of the first co-owner to die, if the surviving co-owner is a U.S. citizen. Otherwise, the entire value of property owned jointly with a right of survivorship by a decedent and a surviving co-owner is included in the decedent's gross estate under § 2040(a), except to the extent that it can be shown that the surviving joint owner contributed part of the purchase price. For a married couple who are Texas residents, Texas law governs the character and ownership of property. Even though 'title' to property may be listed in one spouse's name, each spouse owns a one-half interest in that property. *See* TEX. CONST. ART. XVI, §15 (1987). For example, with life insurance, the IRS recognizes the fact that in a community property state, a husband and wife each own one-half of a policy, regardless of the fact that the surviving spouse may have been listed on the contract as the owner of the policy. *Est. of Cervin v. Commissioner*, 111 F.2d 1252 (5th Cir. 1997). Under these circumstances, the interest of the non-insured, surviving spouse's community property interest is not included in the insured's estate. Treas. Reg. §20.2042-1(c)(5); *Davis v. Prudential Ins. Co. of America*, 331 F.2d 346 (5th Cir. 1964); *Freedman v. U.S.*, 382 F.2d 242 (5th Cir. 1967); *Est. of Cervin v. Commissioner*, 111 F.2d 1252 (5th Cir. 1997). In *Hornor Est. v. Commissioner*, 44 B.T.A. 1136 (1941), *aff'd*, 130 F.2d 649 (3d Cir. 1942), a decedent and his wife transferred property held by them as tenants by the entirety to a trust that was revocable by joint action of both tenants during their joint lives, reserving the income for their joint lives and the life of the survivor. The decedent had furnished all of the consideration for the purchase of the transferred property. The Tax Court held that the entire value of the trust assets was includible in the decedent's gross estate under the predecessor to § 2040(a), because retention of a power of revocation negated the attempted severance of the joint ownership for federal estate tax purposes. In *Black v. Commissioner*, 765 F.2d 862 (9th Cir. 1985), *rev'g* T.C. Memo 1984-136, however, the Ninth Circuit held that transfer of property to a joint revocable trust did change the nature of the ownership. Therefore, the trust terms constituted an agreement to modify the right of survivorship and severed the joint tenancy, and § 2040 did not apply.

D. Qualified Retirement Plan Benefits Paid to a Revocable Trust.

1. In General. One of the major assets available to the clients is their interest in employer-provided qualified retirement plans or individual retirement accounts (IRAs). Naming a revocable trust as the beneficiary of retirement plan benefits is one of the devices available to clients who want ongoing management and other trust benefits for these assets. For a detailed discussion of estate planning for qualified retirement plans, see Mezzullo, *Estate and Gift Tax Issues for Employee Benefit Plans*, 814-3rd TAX MGMT. PORT. (BNA).

2. Income Taxation of Retirement Plan Death Benefits Paid to a Revocable Trust. A participant in a qualified plan or IRA, or the beneficiary of a participant, is taxed on the greater of the amount withdrawn from the plan in the taxable year or the amount that is required to be withdrawn (the required minimum distribution). Section 401(a)(9) requires that distributions be made over: (1) the life of the employee (participant); (2) the joint lives of the employee and a designated beneficiary; (3) a period not exceeding the life expectancy of the employee; or (4) a period not exceeding the joint life expectancy of the employee and a designated beneficiary. IRC § 401(a)(9)(A)(ii); Treas. Reg. § 1.401(a)(9)-2, Q&A-1(a). Generally, death benefits payable to the beneficiaries of a qualified retirement plan are treated as ordinary income upon receipt, the taxation of which has merely been deferred until after the participant's death. IRC § 72. Amounts paid to a "designated beneficiary" are required to be distributed (and thereby taxed), in not less than substantially equal payments over the beneficiary's life expectancy. IRC § 401(a)(9)(B)(iii). However, amounts due on account of the death of a participant who dies without a designated beneficiary must be distributed in full by the end of the fifth year following the year of the participant's death if payments had not begun when the participant died. IRC § 401(a)(9)(B)(ii). If payments have begun by the time of the participant's death, and the participant has no designated beneficiary, the plan balance must be distributed over the participant's life expectancy (or a period not exceeding the participant's life expectancy). IRC § 401(a)(9)(B)(i); Treas. Reg. § 1.401(a)(9)-2.

3. Trusts as Designated Beneficiaries. Generally, the designated beneficiary must be an individual. IRC § 401(a)(9)(E); Treas. Reg. § 1.401(a)(9)-4, Q&A-1. However, the underlying beneficiary of a trust can serve as the designated beneficiary for purposes of determining required minimum distributions when the trust is named as the beneficiary of a retirement plan or IRA, if certain requirements are met. Treasury Regulations finalized in 2002 greatly simplified the manner in which taxpayers calculate their required minimum distributions from a qualified plan, IRA, or other related retirement savings vehicles. In part, the new regulations clarify the treatment of distributions to a trust. Unfortunately, by "greatly simplified," I mean that the rules went from incomprehensible to merely mind-boggling. For a detailed discussion of these extremely technical rules, see Streng and Davis, RETIREMENT PLANNING: TAX AND FINANCIAL STRATEGIES (Warren Gorham & Lamont 2011) ¶ 5.03[13].

4. Revocable Trusts as Beneficiaries. The final regulations permit the beneficiary of a revocable trust to be the designated beneficiary for purposes of determining the minimum distribution, if (i) the trust is valid under state law; (ii) the trust becomes irrevocable upon the death of the employee; (iii) the beneficiaries of the trust are identifiable from the trust instrument; (iv) a copy of the trust instrument is provided to the IRA trustee or custodian or plan sponsor; and (v) the trust beneficiaries are all "designated beneficiaries." Treas. Reg. § 1.401(a)(9)-4, Q&A-5, *see also,* Streng and Davis, RETIREMENT PLANNING: TAX AND FINANCIAL STRATEGIES (Warren Gorham & Lamont 2011) ¶ 5.03[13][c]. With regard to revocable trusts, the regulations also state that the employee must either: (a) provide a copy of the revocable trust instrument to the plan administrator and agree to provide a copy of each amendment that is later made; or (b) provide the plan administrator with a list of all the beneficiaries of the trust, a description of their entitlement and any conditions on their entitlement, and a certification that the list is correct and complete and that the other requirements for the beneficiaries of the trust to be treated as designated beneficiaries are satisfied. Treas. Reg. § 1.401(a)(9)-4, Q&A-6. In the latter situation, the employee must also agree to provide corrected certifications to the extent that changes occur. *Id.* For planning implications that may arise when a joint revocable trust is used as a plan beneficiary, see Section IV. G. , below.

IV. SPECIAL CONCERNS FOR REVOCABLE TRUSTS—POST-DEATH

A. Should Probate Be Avoided? Because Texas law permits independent administration of estates, informal (non-judicial) estate administration allows for a relatively inexpensive and expedient probate procedure. Judicial supervision of decedents' estates is often available if needed, where, for example, parties are in conflict, construction of language used in the will is necessary, or for other reasons. Where the court does not need to be involved or remain involved in the administration of an estate, probate, like trust administration, is handled essentially as an office procedure. Sometimes, however, the formalities of probate provide a valuable benefit. It is a sad truth that some individuals are better behaved when their actions are subject to public scrutiny. The privacy and lack of supervision afforded a trustee of a revocable trust could be used by a trustee to surreptitiously circumvent the desires of the grantor. The simple solution is to select a trustee whose ethics are beyond question. Unfortunately, in some cases, the true character of the chosen trustee is not evident until after he or she has yielded to the temptation of greed or self-interest.

B. Susceptibility (and Lack Thereof) to Challenge (Will Contests). A disgruntled beneficiary can challenge the validity of a decedent's will on the grounds of the decedent's incompetency, undue influence, fraud against the decedent leading to certain dispositions, or the failure of the will to meet all of the formal requirements, such as the appropriate number of attesting and subscribing witnesses.

1. Contesting Revocable Trusts. Similar to the law of wills, under the Uniform Trust Code, a trust can be contested on a variety of grounds. For example, the contestant may allege that no trust was created due to lack of intent to create a trust or lack of capacity, UNIF. TRUST CODE § 402; that undue influence, duress, or fraud was involved in the trust's creation, *Id.* at § 406; or that the trust had been revoked or modified. *Id.* at § 602. Under the Uniform Trust Code, the capacity required to create, amend, revoke, or add property to a revocable trust, or to direct the actions of the trustee of a revocable trust, is the same as that required to make a will. *Id.* at § 601 The Code also provides limitations on actions to contest the validity of a revocable trust. *Id.* at § 604. Section 112.007 of the Texas Trust Code provides that the capacity of a person to create a trust is the same as the capacity to create a will. As with the Uniform Trust Code, this seems to suggest that there is the ability to contest a grantor's capacity in relation to the creation of a trust, however, there is very little case law or success in this regard.

2. Standing. The primary difficulty in challenging a revocable trust is the lack of clear law defining the standards and procedures for such challenges. Section 115.011(a) of the Texas Trust Code provides that "[a]ny interested person may bring an action relating to a trust." Section 115.011(b) provides that the necessary parties to an action include certain trust beneficiaries, a person receiving distributions from the trust, and the trustee. In 2011, this section was amended to make it clear that a beneficiary must be a beneficiary of the trust and if named, his or interest cannot have been terminated. TEX. PROP. CODE §115.004(b). "Interested person" is defined in Section 111.004(7) of the Texas Trust Code to include "a trustee, beneficiary, or any other person with an interest in or claim against a trust, or any person affected by the trust administration." In *Lemke v. Lemke*, 929 S.W.2d 662 (Tex. App. – Fort Worth, 1996, *writ denied*), the court demonstrated the limitations on the definition of "interested person" by finding in a divorce case that the wife of a grantor was not an interested person because she was not a current or remainder beneficiary or a trustee of a trust that her husband had established for his benefit, she had no claim against the trust, she was not affected by its administration, and she had no community property interest in the trust principal. A number of principles have been cited as impediments for contesting revocable trusts, both before and after the settlor's death.

a. Beneficiary Lacks Standing While Trust Is Revocable. Section 111.004(2) of the Texas Trust Code defines "beneficiary" as "a person for whose benefit property is held in trust, regardless of the nature of the interest." In addition, Section 111.004(6) defines an "interest" as any interest, including legal, equitable, present, future, vested or contingent. Prior to 2007, Texas had not dealt with the issue of whether a contingent beneficiary of a revocable trust had standing to challenge the trust. Other jurisdictions had dealt with this issue, holding that a contest may not be brought challenging the validity of a revocable trust until the settlor has died or the right to revoke has otherwise terminated, because until that date no beneficiary has a fixed right in the trust dispositions. *See, e.g., Ullman v. Garcia*, 645 So. 2d 168 (Fla. Dist. Ct. App. 1994)(no authority to challenge revocable trust prior to death of settlor); *In re Malasky*, 290 A.D.2d 631, 736 N.Y.S.2d 151 (2002) (only the decedent and his wife had interests in the income and principal of the trust during their respective joint lives; the children had no pecuniary interest in the trust during that time). In 2007, a Texas appeals court followed the reasoning that a contingent beneficiary's interest must be vested in order for the beneficiary to be an interested person. *Moon v. Lesikar*, 230 S.W.3d 800 (Tex.App. – Houston [14th Dist.] 2007, *pet. denied*). The court reasoned that when the grantor and trustee of a trust are the same person, the grantor is the sole beneficiary during his life, and the grantor has the power to revoke the trust such that the contingent beneficiary's interest is subject to the grantor's discretion until the grantor's death, a contingent beneficiary had no standing to complain about the grantor's disposition of trust assets. *Id.* at 804-806.

b. Challenge after Settlor's Death. In *Matter of Davidson Est.*, 177 Misc. 2d 928, 677 N.Y.S.2d 729 (N.Y. Sur. Ct. 1998), the court stated that revocable trusts were used as testamentary instruments and that they should be treated as similarly to wills as possible. Such treatment, the court stated, includes allowing a person whose situation with respect to a trust is similar to that of a contestant under a will to bring suit challenging the validity of the trust. The court also noted, however, that there is no clear guideline regarding which party may sue to contest a trust, or what type of relief he or she may seek. A person who is interested in the trust could, for example, sue to set the trust aside, seek limited letters of administration for the purpose of bringing a discovery proceeding to determine the assets of the trust, sue to have the trust assets turned over to the executor, or sue to rescind the trust (if the plaintiff were the decedent's executor or administrator).

3. Fraud and Undue Influence. Although some commentators suggest that the standard for establishing fraud or undue influence with respect to inter vivos transfers may differ from that for testamentary transfers, the best analysis is that the standards for proving undue influence in a contest against a revocable trust should be the same as those applied in contesting a will. *See Upman v. Clarke*, 736 A.2d 380 (1999), *aff'd*, 753 A.2d 4 (2000) (the same standards should apply in determining if undue influence was exerted upon the settlor of a revocable trust as apply for the purpose of challenging the validity of a will); *Mercado v. Trujillo*, 980 P.2d 824 (Wyo. 1999) (revocable trust attacked as product of undue influence was treated as testamentary disposition and burden of proof was on contestant); *Matter of Tisdale Est.*, 171 Misc. 2d 716, 655 N.Y.S.2d 809 (N.Y. Sur. Ct. 1997) (suit to set aside revocable trust based on undue influence and fraud triable before jury, as would probate contest; revocable trust effectively substitute for will). *Cf. Matter of Aronoff Est.*, 171 Misc. 2d 172, 653 N.Y.S.2d 844 (N.Y. Sur. Ct. 1996) (reaching an opposite conclusion with which the *Tisdale* court disagreed). The Restatement (Third) of Trusts § 11(2)(2001) adopts the testamentary rule with respect to questions of capacity, providing: "A person has capacity to create a revocable inter vivos trust by transfer to another or by declaration to the same extent that the person has capacity to create a trust by will." The official comments reiterate that revocable trusts ordinarily function as a will substitutes and should, therefore, be evaluated with the same standards applicable to wills. RESTATEMENT (THIRD) OF TRUSTS § 11 cmt. b (2001). Because Section 112.007 of the Texas Trust Code likens the capacity to create an inter vivos trust to that of a person to make a will, it seems that in Texas, the standards for contest should be similar, if not the same.

4. Procedural Requirements. Some states have adopted statutory rules that describe how (and when) to challenge a revocable trust. For example, the California Probate Code provides that the trustee of a revocable trust must notify the beneficiaries when the trust becomes irrevocable, and the beneficiaries then have 120 days within which to contest the trust. CAL. PROB. CODE §§ 16061.7, 16061.8. *See also* Beauchamp, *'It's My Money 'Til I Die': When Trustees Must Notify Heirs and Beneficiaries Concerning a Trust That Has Become Irrevocable*, 32 MCGEORGE L. REV. 670 (2001). Many states, however, do not clearly delineate the procedural requirements for challenging a revocable trust. The trend appears to be to extend the rules for contesting a will to contesting a revocable trust if the trust functions primarily as a part of testamentary estate plan. *See* Zaritsky, *Revocable Inter Vivos Trusts*, 860-1st TAX MGMT. PORT. (BNA) at III.G.3.

C. Long Arm Jurisdiction. What if the trustee is located in a state other than the state in which the settlor is located? Generally, a suit can be filed against a defendant only by serving the defendant with process within the state in which the suit is filed. A plaintiff may serve a defendant who is not present within the state by constructive or substituted service under the long-arm statute in most states. In most cases, long-arm statutes allow service on non-resident defendants who "do business" within the state. RESTATEMENT (FIRST) OF JUDGMENTS § 22 App. (1982); RESTATEMENT (SECOND) OF JUDGMENTS §§ 2, 5 (1980). Is the trustee of a revocable trust considered to be doing business? Many long-arm statutes expressly extend to "executors" and "personal representatives." These terms have sometimes been interpreted to extend to the trustee of a revocable trust. *See Nile v. Nile*, 432 Mass. 390, 734 N.E.2d 1153 (2000). *Cf. Matter of Ducey Est.*, 787 P.2d 749 (Mont. 1990) (court did not acquire either in rem or in personam jurisdiction over Nevada bank serving as trustee of decedent's revocable trust created in Nevada naming Nevada bank as trustee after settlor moved to Montana where she was domiciled when she died).

D. Impact upon Statutory Rights of Heirs.

1. Interests of a Surviving Spouse.

a. Homestead, Exempt Property and Family Allowance. The Texas Probate Code provides several protections to a surviving spouse in the form of the probate homestead (TEX. CONST. ART. XVI, §52 (1987), TEX. PROB. CODE § 270), exempt property set-aside (TEX. PROB. CODE § 271 *et seq.*), and the family allowance (TEX. PROB. CODE § 286 *et seq.*). No similar provisions exist under the Texas Trust Code, so the question becomes whether a surviving spouse loses these protections when estate planning has been done through a revocable trust. Professor Thomas Featherston provides an excellent discussion of the issues involved. Featherston, *Representing the Surviving Spouse: A Handbook for the Lawyer of the Decedent's Spouse*, 34th Annual State Bar of Texas Adv. Est. Planning and Prob. Course (2010). In order to preserve the life estate granted to a surviving spouse in the homestead, Professor Featherston cautions that the homestead right should be spelled out in the trust agreement. In addition, regardless of the separate or community property characterization of the homestead, both spouses should join in the conveyance to the revocable trust in order for the conveyance to be effective. TEX. FAM. CODE § 5.001. While arguments can be made that homestead protections are still available to the surviving spouse as a constitutional right and therefore do not rely solely on the power of a probate court, the exempt property set-aside and the family allowance are rights that may be ordered only by a probate court. Since a revocable trust avoids probate, the surviving spouse has arguably given up his or her right to these protections. In addition, certain children of the decedent also have these rights, so these children arguably lose these protections as well.

b. Elective Share Rights Generally. In non-community property states, a surviving spouse has the right to renounce the terms of the decedent's will and take instead a specified share of the estate. This elective share may take the form of common law dower or curtesy. The share may be a right to a life estate in one-third of the decedent's real estate or a fixed percentage of the decedent's real and personal property, often depending on whether there are surviving descendants of the decedent or whether any surviving descendants of the decedent are also descendants of the surviving spouse. Some clients (either residents of those states or Texans owning property in those states) may wish to prevent their surviving spouse from enforcing these elective share rights. Their goals may sometimes be accomplished through a premarital or post-marital agreement, or lifetime transfers, depending upon applicable state law. As outlined below, in some states, a revocable trust may be effective to limit the elective share rights of a surviving spouse.

(1) Illusory Transfers. A transfer to a revocable trust may be regarded as illusory for elective share purposes, even when the trust is treated as a valid entity for other state law purposes. *See* Russo & Kirkwood, *The Use of a Revocable Trust to Defeat the Elective Share*, 57 FLA. B.J. 110 (1983). State law is critical in determining whether funding a revocable trust removes assets from the base for determining the surviving spouse's elective share. The Uniform Probate Code states that the elective rights of a surviving spouse apply to a decedent's "augmented estate," which includes the value of any property transferred by the decedent during his or her lifetime for less than adequate consideration in money or money's worth, over which the deceased retained a power to revoke or in which the deceased retained an income interest. UNIF. PROBATE CODE §§ 2-201(6) and 2-205(2). Other states have adopted similar provisions. *See, e.g.,* N.Y. EST. POWERS & TRUSTS LAW § 5-1.1-A(b)(1)(F).

(2) The Traditional Rules. Under the law of states that have not adopted the augmented estate concept, the results may vary. In general, states have been divided into two camps.

(a) The New York Rule. Some states follow the so-called "New York rule," enunciated in *Newman v. Dore*, 275 N.Y. 371, 9 N.E.2d 966 (1937). Mr. Strauss's will purported to leave his wife an amount equal to her statutory share, but three days before his death, Mr. Strauss transferred all of his property to a revocable trust of which his wife was not a beneficiary. The court adopted the test of whether the transfer itself was "illusory" and whether the decedent had divested himself of ownership of his property. The court noted that the settlor had reserved virtually identical powers to those he held over the property before it was transferred to the trust and, therefore, held that the transfer was illusory and ineffective to defeat the surviving spouse's rights. Somewhat ironically, the New York rule was later rejected by statute in New York. N.Y.Est. Powers & Trusts Law § 5-1.1-A(b)(1)(F). It is nevertheless still followed in other jurisdictions. *See* Dees, *A Response to* Johnson v. La Grange State Bank: *Restoring Forced Share Protection for the Surviving Spouse*, 1980 ILL. L.F. 277 (1980); Hayes, *Illinois Dower and the 'Illusory' Trust: The New York Influence*, 2 DEPAUL L. REV. 1 (1952); Kemper, Annotation, *Validity of Inter Vivos Trust Established by One Spouse which Impairs the Other Spouse's Distributive Share or Other Statutory Rights in Property*, 39 A.L.R. 3d 14 (1971). Note the similarity to the facts in *Land v. Marshall*, 462 S.W.2d 841 (Tex. 1968).

(b) The Massachusetts Rule. In *Kerwin v. Donaghy*, 317 Mass. 559, 59 N.E.2d 299 (1945), the Massachusetts Supreme Judicial Court arrived at a different result on very similar facts. The deceased had, for many years, put his assets in his children's names as part of a general plan to avoid federal income taxes. Before the decedent's death, however, these assets had been returned to him and he had transferred his investment assets to two revocable trusts, retaining the right to receive all the trust income, and naming his daughter as trustee. The widow renounced the will, under which she was to receive approximately one-fifth of his estate, and claimed a statutory share, arguing that it included, for this purpose, the assets of his revocable trust. The court disagreed, holding that the widow's elective share did not extend to property that the husband had transferred during his life, regardless of the rights he retained over the transferee trust. The Massachusetts Rule might better be referred to as the "old Massachusetts rule" because it has since been rejected by the state that first adopted it. In *Sullivan v. Burkin*, 390 Mass. 864, 460 N.E.2d 572 (1984), the Massachusetts Supreme Judicial Court adopted the New York rule for traditional Massachusetts revocable trusts, announcing that Massachusetts would no longer follow *Kerwin*. The court recognized significant changes since 1945 in public policy considerations bearing on the right of one spouse to treat his or her property as he or she wishes during marriage. It abandoned the *Kerwin* rule prospectively, holding that the surviving spouse's elective share extended to transfers over which the deceased retained a power to revoke. Several states still follow the rule that one spouse can defeat the other's elective rights by creating a revocable trust and transferring his or her assets to it. *See Dumas v. Dumas Est.*, 68 Ohio St. 3d 405, 627 N.E.2d 978 (1994); *Pezza v. Pezza*, 690 A.2d 345 (R.I. 1997); *Seifert v. S. Nat'l Bank of South Carolina*, 305 S.C. 353, 409 S.E.2d 337 (S.C. 1991); *Briggs v. Wyoming Nat'l Bank of Casper*, 836 P.2d 263 (Wyo. 1992). *But see, Johnson v. Farmers & Merch. Bank*, 180 W. Va. 702, 379 S.E.2d 752 (1989) (reversing West Virginia's prior position and adopting position that revocable trust will not defeat spouse's elective share if it diminishes the probate estate to the extent that the spouse has nothing to elect against).

2. Transfers in Fraud of Elective Share Rights. A transfer to a revocable trust may be set aside as a fraud on the spouse's elective share rights, even in states that otherwise permit such (non-fraudulent) transfers to defeat the elective share. The doctrine of fraud on marital rights is a judicial attempt to balance the deceased spouse's right to alienate property against the need to protect the surviving spouse's legal share. To be set aside as fraudulent in most states, lifetime transfers must be made with an *intent* to deprive the surviving spouse of his or her elective rights, and under circumstances in which it would be unfair to permit the transfers to stand. Courts will set aside a transfer that was made with the primary objective of defeating the spouse's rights, looking at all of the relevant facts. *See, e.g., Knell v. Price*, 318 Md. 501, 569 A.2d 636 (1990) (retention of control and beneficial enjoyment was a virtually dispositive indication of fraud). *See also Durant v. Durant*, 294 Pa. Super. 202, 439 A.2d 821 (1982); *Aronson v. Aronson*, 25 Mass. App. Ct. 164, 516 N.E.2d 184 (Mass. Ct. App. 1987) (husband's conveyance of property to irrevocable trust for his children one month before filing for divorce from wife was set aside as fraudulent, despite claim that it was part of an ongoing estate planning process); *Wachter v. Wachter*, 178 W. Va. 5, 357 S.E.2d 38 (1987); *McClure v. Stegall*, 729 S.W.2d 263 (Tenn. Ct. App. 1987.

3. Applying the Law of a Non-domiciliary State. If the state in which an individual resides does not permit him or her to use a revocable trust to limit a surviving spouse's elective rights, it may be possible to create a trust in another state and thereby defeat his or her spouse's rights. Unfortunately, the case law regarding the question of which law controls is inconsistent. Sections 242 and 265 of the Restatement (Second) of Conflict of Laws state that the law of the situs of the real property determines the elective rights of a surviving spouse as to the decedent's real estate, but that the law of the decedent's domicile determines the spouse's rights with respect to movables. A reporter's note points out that a surviving spouse who elects to take under the decedent's will in the domiciliary state may be precluded from claiming an elective share in real estate held in other states. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 242 reporter's note (1971). Similarly, renunciation of the will in the domiciliary state often will preclude a claim in the ancillary states. However, a renunciation or expression of an intent not to renounce in a state of ancillary administration may not be binding on the domiciliary state. *See generally* Brazener, Annotation, *Conflict of Laws Regarding Election for or Against Will, and Effect in One Jurisdiction of Election in Another*, 69 A.L.R. 3d 1081 (1976). If an individual who wishes to limit a spouse's elective rights cannot do so in his or her own state, the estate planning should consider the following factors to create a viable basis for adopting another state's laws: (1) the trust should be executed in the other state, consistent with all required formalities; (2) the trust assets should be held by a trustee in the other state at its place of business there; (3) the trust instrument should recite that the adopted state's laws apply in all matters; (4) the trust should be funded with personal property or real estate having a situs in the other state; and (5) the trustee should be as independent as possible, to guard against attack under the fraudulent transfer or illusory trust doctrines. *See* Zaritsky, *Revocable Inter Vivos Trusts*, 860-1st TAX MGMT. PORT. (BNA) at IV.B.2.d.

4. Rights of Electing Spouse in Revocable Trust Assets in Addition to Statutory Share. A decedent who has both significant personal assets held outside a revocable trust, and assets held in a revocable trust that benefits the surviving spouse, may actually increase the surviving spouse's share of the estate in the event that the surviving spouse elects to claim a statutory share. Several courts have held that a surviving spouse's renunciation of the decedent's will did not preclude the surviving spouse from retaining an income interest in the decedent's revocable trust. *See Lorch v. Mercantile Trust Co. Nat'l Ass'n*, 651 S.W.2d 540 (Mo. Ct. App. 1983); *Carnahan v. Stallman*, 504 N.E.2d 1218 (Ohio Ct. App. 1986); Bravo v. Sauter, 727 So. 2d 1103 (Fla. Dist. Ct. App. 1999); Atkins, Note, *Surviving Spouse's Election and Acceleration of Remainders in Pour-Over Trusts*, 41 U. CIN. L. REV. 441, 448 (1972)). A contrary result was reached by a Pennsylvania court in *In re Clark's Est.*, 8 Pa. D. & C.2d 665, 7 Fiduc. Rep. 73 (Pa. Orphans' Ct. 1956).

5. The Omitted Spouse. State law usually grants a spouse who was unintentionally omitted from a decedent's will a right to claim an intestate share of the estate. Bulcroft & Johnson, *A Cross-National Study of the Laws of Succession and Inheritance: Implications for Family Dynamics*, 2 J.L. & FAM. STUD. 1 (2000). Most state laws do not expressly extend these rules to revocable trusts, and the courts have not yet opined on whether the marriage of the settlor should alter the dispositions under a revocable trust. California does, however, extend the omitted spouse rule to revocable trusts. CAL. PROB. CODE §§ 21601, 21610-21612.

E. Statutory Shares of Settlor's Children. A child does not generally have elective share rights in the estate of a deceased parent in common law jurisdictions, but special rights may be afforded in those jurisdictions to pretermitted or adopted children. Countries that operate under a civil law system and the State of Louisiana, because of its civil law background, do grant certain children elective rights ("forced heirship") in a deceased parent's estate. A revocable trust may be used to limit or frustrate these rights in certain cases.

1. Pretermitted Heirs. Nearly all jurisdictions have statutes providing an intestate share for an omitted child or the omitted issue of a deceased child, unless the omission was intentional. *See, e.g.,* TEX. PROB. CODE § 67. These pretermitted heir statutes do not usually refer to inter vivos trusts, and the courts are not inclined to interpret them as applying to revocable trusts. *See, e.g., Robbins v. Johnson*, 780 A.2d 1282 (N.H. 2001). A settlor's issue may, therefore, have fewer statutory rights in assets held in a fully funded revocable trust than in assets passing under the deceased settlor's will, because the pretermitted heir statutes apply only to wills unless the will contains a specific declaration that an omission is intentional and not occasioned by accident or mistake. An inadvertent omission in an inter vivos trust cannot usually be cured by such corrective statutes, even if it is shown that the settlor and the drafter simply overlooked the possibility that issue might be born after the execution of the instruments. Section 67 of the Texas Probate Code, although not specifically referring to inter vivos trusts, does apply if a child "is not mentioned in the testator's will, provided for in the testator's will, *or otherwise provided for by the testator*" which seems to suggest that if a pretermitted child is not mentioned in the trust, he or she could seek a share of the estate. Whether the pretermitted child would be able to force a distribution from the revocable trust is unclear. The better drafting practice is to define children in the revocable trust to include any after-born or -adopted children.

2. Adopted Children. The majority of statutes giving adopted children inheritance rights equivalent to those given to natural-born children apply only to wills. *See, e.g.,* TEX. PROB. CODE § 40. These statutes presume that words such as "children" and "issue" are intended in a will to include adopted children and issue; the will can state otherwise. Courts have not expressly extended their scope to revocable trusts that are used as will substitutes. As a result, a trust instrument should specify whether adopted children should have the same rights as natural-born children. The trust instrument should also indicate the settlor's intentions with respect to a child who was adopted during adulthood.

3. Forced Heirship. Jurisdictions with a civil law system, such as Louisiana, give some surviving children "forced heirship" rights. *See* LA. CIV. CODE ANN. arts. 1493 – 1495. A revocable trust may be used to defeat the forced heirship rights of a child, though there is apparently no case law on this point and one would probably have to argue by analogy to the effect of a revocable trust on the rights of a surviving spouse under applicable law. *See Watts v. Swiss Bank Corp.*, 27 N.Y.2d 270, 265 N.E.2d 739 (1970) (elective forced heirship under French law was not cut off by a revocable trust, because of applicable choice-of-law principles).

F. Rights of Creditors. It is clear from the Texas Property Code that spendthrift language in a revocable trust will not protect the trust assets from the grantor's creditors during the grantor's life. TEX. PROP. CODE § 112.035(d). In contrast, it is not clear whether the spendthrift language will protect the assets from the grantor's creditors after his death. *See FCLT Loans, L.P. v. Estate of Bracher*, 93 S.W.3d 469 (Tex App. – Houston [14th Dist.] 2002, *no pet.*). Although Part 4 of Chapter VIII of the Texas Probate Code sets forth a detailed claims procedure to be followed for a decedent's estate, no similar procedure is provided for in the Texas Trust Code.

G. Retirement Plans and Non-Pro Rata Divisions of Community Property. In the context of community property, estate planners often seek after the death of the first spouse to make a non-pro rata division of community property assets, so that instead of half of each and every asset being owned by the surviving spouse and the beneficiaries of the deceased spouse's estate, some assets are owned entirely by each. Can an executor and the surviving spouse make tax free non-pro rata divisions of community property, so that the beneficiaries own 100% of a community property asset while the spouse succeeds to 100% of other community property assets of equal value? Two 1980 technical advice memoranda suggest that such a tax-free division is permissible. Both rely on Revenue Ruling 76-83, 1976-1 C.B. 213, a ruling involving similar issues in the divorce context, which has since been rendered obsolete by the enactment of § 1041 which expressly provides for non-recognition in the divorce context. TAM 8016050; TAM 8037124. A more recent ruling in the estate context seems to confirm this analysis, so long as the division is if permitted by the governing instrument or by local law. TAM 9422052. The stakes in regard to this issue are especially high if one of the assets at issue is a retirement plan or IRA. If the non-pro rata division is not allowed, the beneficiaries may be treated as "selling" their one-half interest in the exchanged assets to each other, with disastrous income tax consequences. *See* Rev. Rul. 69-486, 1969-2 CB 159. A possible method of effecting this split without adverse tax consequences involves the use of a funded joint revocable trust, with both spouses serving as grantors, and the trust named as the beneficiary of the plan or IRA. The trust would include a specific provision allowing non-pro rata in-kind distributions.

1. PLR 199912040. In Private Letter Ruling 199912040, decedent died at the age of 72, with a pour-over Will and a revocable trust as the primary dispositive vehicle. All property was community property. There is no statement in the ruling as to how the IRA became subject to the trust, but the language used indicates that decedent owned it at his death. One can only assume that the trust was the named beneficiary. The surviving spouse was the trustee of the trust and the executor of the estate. The trust specifically provided for non-pro rata distributions in kind. The trust was a standard trust with an irrevocable bypass trust, and a survivor's trust which contained all of the surviving spouse's property and the decedent's community property in excess of that required to fund the bypass trust. The surviving spouse proposed to allocate 100% of the IRA to the survivor's trust, which she could revoke and over which she had complete control. It was represented to the IRS that state law allowed non-pro rata distributions, but the ruling gives no further guidance as to whether this feature was provided for by statute or under the common law; it cites no authority. The IRS determined that the non-pro rata funding will not "differ materially" from the required funding of the two trusts, and thus did not constitute a taxable exchange. The IRS distinguished Revenue Ruling 69-486, in which the IRS held that non-pro rata funding by the trustee based upon the agreement of the two beneficiaries created a taxable event because neither the trust nor state law permitted non-pro rata funding. Rev. Rul. 69-486, 1969-2 CB 159. The Service held also that the distribution of the IRA to the trust and the subsequent transfer to the surviving spouse was not a transfer of income in respect of a decedent under § 691(a)(2). *See also* PLRs 199925033; 199937055; 200928043.

2. PLR 200950053. Private letter ruling 200950053, to a large extent, reaches the same result as the prior rulings noted. It makes clear that it is not necessary that the IRA be an asset of the joint revocable management trust, so long as the trustee is the named as the beneficiary of the IRA. As in the other rulings, the IRA owner predeceases the non-participant spouse. The trust contains an ability to allocate non-pro rata among the martial trust (which, under the facts of the ruling would not be funded), the bypass trust and the survivor's trust which contained the surviving spouse's one-half of the community plus her separate property. The survivor's trust was revocable by surviving spouse, who was also the trustee. The taxpayer represented that the community estate would be allocated equally between the bypass and the survivor's trust, and that the entire IRA would be allocated to the survivor's trust. The surviving spouse would then revoke the survivor's trust, distribute the IRA to herself, and then, within sixty days, roll the proceeds over to a spousal IRA pursuant to § 408(d)(3). The IRS ruled that the allocation prescribed by the trust, and allowed by state law, was effective, and that the surviving spouse was in complete control with the power to revoke the survivor's trust and rollover the distributed IRA tax free into her IRA. The Service further ruled that state law, not § 408(g) (which generally pre-empts state community property laws as applied to IRAs), controlled. Therefore there would be no income recognition as a result of the non-pro rata exchange. It should be noted that this ruling involved an IRA. Its holding may apply by analogy to qualified plans, although the statutory analysis would be somewhat different.

3. PLR 201125047. With some different wrinkles in the facts, the IRS has recently approved another non-pro rata division of assets involving an IRA. The decedent died with a pour-over Will and a revocable trust as his primary dispositive vehicle. In this case, the trust was a joint revocable trust. All assets at issue were community property. The trust provided for the creation of a family trust and marital trusts, one of which was to be a survivor's trust. The surviving spouse was a co-trustee of the marital trust. The revocable trust specifically provided for non-pro rata distributions in kind and the spouse had the power to demand all or a portion of her survivor's trust, at any time. An interesting fact is that the decedent had not named a beneficiary of his IRA and the default rules provided that the beneficiary was his estate. The surviving spouse's community property interest in the IRA was allocated to her survivor's trust and a non-pro rata division of the decedent's interest in the IRA was exchanged for other community property of the surviving spouse, with the result being that all of the IRA was owned by the survivor's trust. The surviving spouse proposed to request the balance of the IRA be paid to her pursuant to the terms of the trust, and within 60 days of such transfer, she would transfer the IRA to a separate IRA for herself as a rollover IRA. Although the governing state is not disclosed, the IRS looked to and cited state law that reads identically to Texas law. Reasoning that because the trust gave the surviving spouse the right to receive any part of the survivor's trust upon her request, the IRS concluded that the IRA would not be an inherited IRA, the surviving spouse was entitled to transfer the IRA to a rollover IRA in her name, and the transfer of the IRA would not cause her to include the proceeds in her gross income.

4. Drafting Lessons. There rulings make it clear that in a properly drafted revocable trust, the IRS is willing to permit the surviving non-participant spouse to make a non-pro rata allocation of all of the IRA (to the extent the assets of the estate or trust permit) to a trust over which the surviving spouse has complete control, which can then be rolled over into the spouse's IRA, leaving other assets to fund the bypass and marital trust. For this technique to work under existing authority, the surviving spouse should be the trustee of the trust (and probably the executor under the Will), the trust must contain a totally discretionary power to make non-pro rata distributions, and the surviving spouse must have the power to revoke (or at least demand distributions) from the survivor's trust. A fully funded joint management trust would seem to work best because, after the participant's death, the non-participant spouse would have not only the participant's one-half of the community property which has poured over to the trust, but also his or her one-half of the community property with which to work. If, for example, a community estate consists of an IRA of $2 million and other community assets of $2 million, and if the unfunded trust is named as beneficiary of the IRA with a pour-over will, then the trust consists of only $3 million (the IRA and one-half of the deceased spouse's community property) and only $1.5 million can be allocated to the survivor's trust. If, however, the trust is fully funded, then because the surviving one-half of the community property is included in the trust, the entire $2 million IRA can be allocated to the survivor's trust and the other $2 million of assets can be placed in the bypass trust. *See* Golden, *It Should Not Be This Hard: A Look at Trusts as Beneficiaries of Retirement Benefits*, 36 ACTEC L. J. 399, 439 (2010).

V. DUTIES OF TRUSTEES AND EXECUTORS CONTRASTED

Two principles underlie much of the Anglo-American law of fiduciary duties: the duties of loyalty and of prudence. Specific duties as applied to trustees and executors vary from state to state, but a number of general principles can be described. The following discussion outlines these general rules. Naturally, the specific laws applicable in the subject jurisdiction should be consulted. In addition, it should be remembered that although estate planning professions (and the IRS) commonly refer to trusts and estates as though they were legal entities, the law generally does not recognize them at such. Instead, courts view trustees and executors personally as charged with various rights and duties with respect to the property under their charge, and the persons who are beneficially interested in that property. The discussion that follows is best understood with that important notion in mind.

A. Fiduciary Duty to Be Generally Prudent.

1. The Trustee. The trustee has a duty to act reasonably and competently in all matters of trust administration, not just in investment matters. Section 113.051 of the Texas Trust Code requires a trustee to "administer the trust in good faith according to its terms and [the Texas Trust Code]." TEX. PROP. CODE § 113.051. *See,* Nelson, *The Prudent Person Rule: A Shield for the Professional* Trustee, 45 Baylor L. Rev. 933 (1993). Section 804 of the Uniform Trust Code provides that a trustee "shall administer the trust as a prudent person would by considering the purposes, terms, distributional requirements, and other circumstances of the trust." In satisfying this standard, "the trustee shall exercise reasonable care, skill, and caution." In other words, there is a duty of "prudent administration." As a general rule, an amateur trustee must exercise "such care and skill as a man of ordinary prudence would exercise in dealing with his own property." RESTATEMENT (SECOND) OF TRUSTS § 174 cmt. a (1959).

2. The Personal Representative. A personal representative must observe the standards in dealing with estate assets that would be observed by a prudent man dealing with the property of another. The Texas Probate Code requires an executor or administrator to take care of the property of the estate "as a prudent man would take care of his own property. . . ." TEX. PROB. CODE § 230. If a personal representative has special skills or is named personal representative on the basis of representations of special skills or expertise, the personal representative is under a duty to use those skills. UNIF. PROBATE CODE §§ 3-703, 7-302.

B. Fiduciary Duty to Invest Prudently.

1. The Trustee. The trustee has a specific fiduciary duty to make the trust property productive, unless the settlor intended otherwise or it is impractical to do so. *See* TEX. PROP. CODE § 117.003 (providing that a trustee owes a duty to the beneficiaries of the trust to comply with the prudent investor rule unless expanded, restricted, eliminated, or otherwise altered by the terms of the trust); RESTATEMENT (THIRD) OF TRUSTS: § 181 cmt. a; § 227 cmt a. *See generally* Bogert & Bogert, TRUSTS AND TRUSTEES § 611 (2d ed. 1991). This specific duty is an offshoot of the trustee's general duty to be prudent and the general duty to carry out the terms of the trust, particularly if the terms make provision for income beneficiaries. TEX. PROP. CODE § 113.051; RESTATEMENT (THIRD) OF TRUSTS § 227 cmt i. Inherent in the duty to make the trust property productive is the duty, as well as the right, to invest the trust property. Bogert & Bogert, TRUSTS AND

TRUSTEES § 702 (2d ed. 1991). Section 227 of the Restatement (Third) of Trusts, the so-called "prudent investor rule," provides a safe harbor for a trustee carrying out investment responsibilities. It does this by holding the trustee to a standard of conduct rather than one of investment performance. In Texas, as in many states, this duty of prudence has been codified. The Texas Trust Code provides:

> A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
>
> A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suitable to the trust.

TEX. PROP. CODE § 117.004. In addition, under Texas law, a trustee must diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. TEX. PROP. CODE § 117.005.

2. The Personal Representative. In contrast to trustees, a personal representative is under a duty to settle and distribute the estate of the decedent in accordance with any probated and effective will as expeditiously and efficiently as is consistent with the best interests of the estate. UNIF. PROBATE CODE § 3-703(a). For example, continuing a decedent's business for purposes of liquidation or sale as a going concern is generally consistent with an executor's limited duties. Establishment of a new business, however, would not be within the scope of an executor's authority. *See Lovenskiold v. Nueces Hotel Co.*, 208 S.W. 759 (Tex. App.–San Antonio 1919, *no writ*). In contrast, note that the Uniform Prudent Investor Act applies only to trustees, and *not to executors*. UNIF. PRUDENT INVESTOR ACT, Prefatory Note: Other Fiduciary Relationships. Accordingly, a personal representative should invest estate assets only for the short term, unless under the circumstances another approach is warranted. As noted above, in dealing with estate assets, a personal representative should observe the standards that would be observed by a prudent man, and if the personal representative has special skills or is named personal representative on the basis of representations of special skills or expertise, the personal representative is under a duty to use those skills. UNIF. TRUST CODE § 7-302.

C. Duty to Control and Protect Trust or Estate Property.

1. The Trustee. The Uniform Trust Code provides that "[a] trustee shall take reasonable steps to take control of and protect the trust property." UNIF. TRUST CODE § 809. These duties are actually "an aspect of the trustee's duty of prudent administration." *Id.* at § 809 cmt.

a. A trustee takes control of the trust property by re-registration, through agents, or by acquiring physical possession, as appropriate. For example, it is now the standard practice of mutual funds to evidence ownership by means of the computer-generated account statement rather than by a paper certificate. Re-registration would therefore be enough. On the other hand, with respect to closely held corporations where paper certificates remain the standard means of evidencing ownership, physical possession would be required as well. Much will depend on the terms of the trust. For example, the settlor may provide that the spouse may occupy the settlor's former residence rent free. In that case, the spouse's occupancy would prevent the trustee from taking possession. *See generally* Rounds, Loring, A TRUSTEE'S HANDBOOK § 6.2.1.1 (2004); Bogert & Bogert, TRUSTS AND TRUSTEES § 583 (2d ed. 1991); 2A Scott & Fratcher, THE LAW OF TRUSTS § 175 (4th ed. 1987). Note that the title to trust property should be in the name of the trustee, e.g. "John Jones, Trustee of the XYZ Trust." They should not be registered in the name of the trust.

b. The trustee should, at trust expense, insure the trust property to the extent it is reasonable to do so. *See* Bogert & Bogert, TRUSTS AND TRUSTEES § 599 (2d ed. 1991).

c. Property taxes should be paid in a timely fashion to avoid a tax sale. *Id.* § 602 (2d ed. 1991); 2A Scott & Fratchery, THE LAW OF TRUSTS § 176 (4th ed. 1987).

d. A legitimate claim against a predecessor trustee or the settlor's estate should be pursued. Bogert & Bogert, TRUSTS AND TRUSTEES §§ 592, 594 (2d ed. 1991); 2A Scott & Fratcher, THE LAW OF TRUSTS § 177 (4th ed. 1987).

e. A trustee who has reason to suspect that a co-trustee is depleting or about to deplete the trust property must take reasonable steps to prevent the co-trustee from doing so. RESTATEMENT (THIRD) OF TRUSTS § 184 cmt. a.

f. A trustee has a duty to take reasonable steps to enforce the trust's claims against third parties and to defend claims against the trust by third parties. Bogert & Bogert, TRUSTS AND TRUSTEES § 581 (2d ed. 1991); 2A Scott & Fratcher, THE LAW OF TRUSTS § 178 (4th ed. 1987). Pursuant to this duty, the trustee has full power to sue on behalf of the trust estate and to defend suits in which it is involved or in which the trustee in involved as trustee. As a general rule, all demands must be pressed, even to the extent of bringing suit, or else the trustee will be liable for a loss caused by unjustified forbearance. On the other hand, it may be in the economic interest of the beneficiaries, and therefore prudent and reasonable, to forbear or to compromise a claim or submit it to arbitration. *See* RESTATEMENT (SECOND) OF TRUSTS § 192.

g. A trustee has a duty of loyalty requiring that the trustee invest and manage trust assets solely in the interest of the beneficiaries. TEX. PROP. CODE § 117.007. A beneficiary of a trust may void a transaction entered into by the trustee that involved an opportunity belonging to the trust. Therefore, a trustee should not enter into a business in direct competition with a business owned by the trust or purchase an investment for the trustee's own account that the facts suggest would have been purchased for the trust. UNIFORM TRUST CODE § 802 cmt. A trustee wishing to exploit an opportunity belonging to the trust or otherwise compete with the trust may, of course, do so notwithstanding the aforementioned proscriptions if the terms of the trust authorize it. Absent express authority in the governing instrument or some enabling statute, however, the trustee could attempt either (i) to obtain the informed consent of all beneficiaries, both current beneficiaries and the remaindermen; or (ii) obtain a court order permitting the trustee to act. A beneficiary's consent to a trustee's act of self-dealing precludes him from holding the trustee liable, but only if when giving consent the beneficiary had full knowledge of all material facts known to the trustee. *Slay v. Burnett Trust*, 187 S.W.2d 377 (Tex. 1945). Either option can be expensive if not problematic when there are unborn or unascertained beneficiaries in the picture. However the trustee attempts to get around the default law, the trustee has an overarching duty to act in good faith toward the trust beneficiaries. This would include fully disclosing to the beneficiaries all information, both of a factual and legal nature, that they would need to protect their equitable interests.

h. If a trust has two or more beneficiaries, the trustee must act impartially in investing and managing trust assets, taking into account any differing interests of the beneficiaries. TEX. PROP. CODE § 117.008.

2. <u>The Personal Representative's Duty to Control and Protect Estate Property</u>. Section 37 of the Texas Probate Code provides that " upon the issuance of letters testamentary or of administration upon any such estate, the executor or administrator shall have the right to possession of the estate as it existed at the death of the testator . . . and he shall recover possession of and hold such estate in trust to be disposed of in accordance with the law." TEX. PROB. CODE § 37. Texas courts have gone so far as to equate the duties of an executor with those of a trustee. The executor holds property interests not for his own benefit, but for the benefit of others. He or she manages those interests under an equitable obligation to act for others' benefit. As a fiduciary, the executor is held to an unusually high standard of ethical and moral conduct in reference to the beneficiaries and their interests. *Geeslin v. McElhenney*, 788 S.W.2d 683, 684 (Tex.App.–Austin 1990, *no writ*). The executor has a duty to collect and take into possession the personal property, record books, title, papers, and other business papers of the estate. TEX. PROB. CODE § 232. The Uniform Probate Code provides that while an estate is being administered, the personal representative may surrender possession or control of any real or tangible personal property comprising the estate to the person presumptively entitled to the property. UNIF. PROBATE CODE § 3-709. The personal representative, however, has the duty to take possession of such property if, in the judgment of the personal representative, possession is necessary for purposes of administration. *Id.* To the extent the personal representative takes possession and control of an asset, he is held to the standard of a trustee with respect to the handling of that asset. *Id.* at § 3-703. A personal representative is required to pay taxes on, and take all steps reasonably necessary for the management, protection and preservation of, the estate in his possession." *Id.* at § 3-709.

D. <u>Duty to Collect Property.</u>

1. <u>The Trustee</u>. A trustee must take reasonable steps to compel a former trustee or other person to deliver trust property to the trustee, and to redress a breach of trust known to the trustee to have been committed by a former trustee. TEX. PROP. CODE § 114.002; UNIF. TRUST CODE § 812. The duty to collect is a specific application of the duty to enforce claims. *Id.* at § 812, cmt. In turn, the duty to enforce claims is an application of the duty to take control of trust property; and all three duties are subsumed in the overarching duty to administer the trust prudently. It is axiomatic that the trustee must take reasonable steps to collect all property due the trust and faces liability for loss because of delay in so doing. *See generally* 2A Scott & Fratcher, THE LAW OF TRUSTS § 175 (4th ed. 1987); Bogert & Bogert, TRUSTS AND TRUSTEES §§ 583, 594 (2d ed. 1991). The duty to collect trust property includes redressing breaches of fiduciary duty by predecessor fiduciaries. *See* RESTATEMENT (SECOND) OF TRUSTS § 223(2)(a). The duty applies as well to the trustee's interaction with executors of pour-over wills, and may even include the trustee's suing an executor personally for the amounts the executor overpaid in inheritance taxes. *See, e.g., Pepper v. Zions First Natl. Bank, N.A.*, 801 P.2d 144 (Utah 1990).

2. The Personal Representative. As noted above, the personal representative of an estate has a duty to collect and take possession of the assets of the estate. TEX. PROB. CODE § 232. Regardless of whether the personal representative actually takes possession of the decedent's property, he, she, or it has a duty to take control of it. See TEX. PROB. CODE § 234; UNIF. PROBATE CODE § 3-709. In so doing, the personal representative must observe the standards of care applicable to trustees. UNIF. PROBATE CODE § 3-703(a). As a result, a personal representative has a fiduciary duty to compel predecessor fiduciaries and others to surrender control of the decedent's property. A successor personal representative has a duty to compel the predecessor personal representative to redress a breach of fiduciary duty known to the successor to have been committed by the predecessor. *DiPortanova v.* Hutchison, 766 S.W.2d 856 (Tex. Civ. App.–Houston [1st Dist.] 1979, *no writ*); UNIF. PROBATE CODE § 3-716. On the other hand, pursuit of a claim for damages against a predecessor would not be appropriate if the amount of the claim, costs of suit and enforcement, and likelihood of recovery would make such action uneconomic. *See* UNIF. TRUST CODE § 812 cmt. (addressing when trustees are relieved of the duty to collect).

E. Duty to Inform and Report.

1. Trustee's Duty to Inform. A fundamental duty of a trustee is to keep the beneficiaries reasonably informed of the administration of the trust. *Huie v. DeShazo*, 922 S.W.2d 920 (Tex. 1996); *Montgomery v. Kennedy*, 669 S.W.2d 309 (Tex. 1984). Secrecy and accountability are incompatible. How much information is enough information? The Uniform Trust Code puts it this way: "A trustee shall keep the qualified beneficiaries of the trust reasonably informed about the administration of the trusts and of the material facts necessary for them to protect their interests." UNIF. TRUST CODE § 813(a). The beneficiary has a right to full information about the concerns of the trust at all reasonable times. Bogert & Bogert, TRUSTS AND TRUSTEES §§ 961, 861 (2d ed. 1991). The beneficiary may examine the trust instrument, the trust property, accounts, and vouchers. *See* UNIF. TRUST CODE § 813 cmt. In the words of the Uniform Trust Code, "[a] particularly appropriate circumstance justifying removal of the trustee is a serious breach of the trustee's duty to keep the beneficiaries reasonably informed of the administration of the trust or to comply with a beneficiary's request for information … Failure to comply with this duty may make it impossible for the beneficiaries to protect their interests … It may also mask more serious violations by the trustee." UNIF. TRUST CODE § 706 cmt. In fact, the trustee may have a duty to give advance notice to the beneficiaries of important events affecting the trust property, e.g., a change in the method or rate of the trustee's compensation or an important transaction involving an asset that is difficult to value or to replace, e.g., real estate or a closely held business interest. UNIF. TRUST CODE §§ 813(a) & (b)(4) and the comment thereto. Under the Uniform Trust Code, the trustee would have a duty to notify the current beneficiaries and the presumptive remaindermen of a proposed transfer of a trust's principal place of administration not less than 60 days before initiating the transfer. UNIF. TRUST CODE § 108(d). Otherwise "[t]he trustee … owes his beneficiary a duty to render at suitable intervals, upon resignation or removal, and upon termination of the trust, a formal and detailed account of his receipts, disbursements, and property on hand, from which the beneficiary can learn whether the trustee has performed his trust and what the current status of the trust is." Bogert & Bogert, TRUSTS AND TRUSTEES § 963 (2d ed. 1991). There is an important exception to the general rule that a trustee has a duty to inform and report: When the trust is revocable by the settlor alone and while the settlor has the capacity to revoke, the trustee may not disclose any information pertaining to the trust to the other beneficiaries, if any, i.e., to those who possess contingent remainder interests. UNIF. TRUST CODE § 603.The trustee's duty to inform under these circumstances runs to the settlor and to the settlor alone. Otherwise, the trustee should respond to a reasonable request for information as soon as possible after the request is received. *See* generally Bogert & Bogert, TRUSTS AND TRUSTEES § 961 (2d ed. 1991).

2. Trustee's Duty to Account. An incident of the trustee's general duty to account and the trustee's particular duty to provide information is the trustee's duty to keep written accounts that show the nature, amount, and administration of the trust property. *See* TEX. PROP. CODE § 113.151; *Corpus Christi Bank & Trust v. Roberts*, 587 S.W.2d 173 (Tex. Civ. App.–Corpus Christi 1979); RESTATEMENT (SECOND) OF TRUSTS § 172; 2A Scott & Fratchery, THE LAW OF TRUSTS § 172 (4th ed. 1987); Bogert & Bogert, Trusts and Trustees § 962 (2d ed. 1991). Texas law requires a trustee to keep full, accurate and orderly records concerning the status of the trust estate and all acts performed by the trustee thereunder. *Shannon v. Frost Nat'l Bank*, 533 S.W.2d 389 (Tex. Civ. App.–San Antonio, 1975, *no writ*). Disclosure to beneficiaries need not take the form of audited financial statements, and when beneficiaries have long accepted informal financial statements and tax returns in lieu of more formal accountings, they may be estopped from insisting upon more formal disclosures. *Beaty v. Bales*, 677 S.W.2d 75 (Tex. App.–San Antonio, 1984, *writ ref'd n.r.e.*). Absent statutory exoneration of the duty, a trust provision that states that the trustee does not have to account to anyone will not be enforced. *See* 2A Scott & Fratcher, THE LAW OF TRUSTS § 172 (4th ed. 1987) n.16 and accompanying text. The courts generally consider such a provision as being against public policy, so it is without effect. Jurisdictions vary as to the necessary form of an account, but in every trust account there should be a clear showing of seven fundamental sets of facts: income received, income disbursed, balance of income on hand, additions to principal, deductions from principal, principal on hand, and changes in investments. The account will ordinarily be presented with debit and credit sides. UNIF. TRUST CODE § 813 cmt. For a model trustee's accounting, see footnote 59 of Bogert & Bogert, TRUSTS AND TRUSTEES § 970 (2d ed. 1991).

3. Personal Representative's Duty to Inform. As with a trustee, an executor has a duty to inform beneficiaries of relevant facts. *Montgomery v. Kennedy*, 669 S.W.2d 309 (Tex. 1984). Section 3-705 of the Uniform Probate Code provides that a personal representative has a fiduciary duty, not later than 30 days after his appointment, to give information of the personal representative's appointment to the decedent's heirs at law and to the decedent's devisees and legatees. The information must include the name and address of the personal representative; that recipients may have an interest in the estate; whether bond has been filed; a description of court where estate papers are on file; that the administration is without court supervision; that recipients are entitled to information from the personal representative regarding the administration of the estate; and that recipients can petition the court in any matter relating to the estate, including distribution of assets and expenses of administration. UNIF. PROBATE CODE § 3-705. The personal representative's failure to give this information is a breach of the personal representative's duty to the person concerned but does not affect the validity of his, her, or its appointment, powers or other duties. *Id.* In addition, a personal representative has a fiduciary duty to prepare an inventory of estate assets. *Id.* at § 3-706. The Uniform Probate Code provides that "within 3 months after appointment, a personal representative shall prepare and file or mail an inventory of property owned by the decedent at the time of his death, listing it with reasonable detail, and indicating as to each listed item, its fair market value as of the date of the decedent's death, and the type and amount of any encumbrance that may exist with reference to any item." *Id.* The personal representative shall send a copy of the inventory to interested persons who request it and may file the original of the inventory with the court. *Id.* If the personal representative breaches his, her, or its fiduciary duty concerning the inventory, the personal representative may be removed. UNIF. PROBATE CODE §§ 3-706; 3-611.

4. Personal Representative's Duty to Account. Under Texas law, any person interested in an estate can demand a detailed accounting at any time after the expiration of fifteen months from the appointment of an independent executor. TEX. PROB. CODE § 149A. Dependent administrators are required to file annual accountings. TEX. PROB. CODE § 399. The Uniform Probate Code provides that a personal representative may, by preparing and filing with the court a closing statement, wind up the affairs of the estate and start the running of the applicable statutory period in which claims against the personal representative for breach of fiduciary duty may be brought. UNIF. PROBATE CODE § 3-1003. A personal representative who fails to disclose matters relevant to his, her, or its liability in the closing statement and in the account of administration furnished to distributees gains no benefit from the applicable statute of limitations. *Id.* at § 3-1005 cmt. The filing must state that the personal representative has done the following: determined that the time limited for presentation of creditors' claims has expired; fully administered the estate of the decedent by making payment, settlement, or other disposition of all claims that were presented, expenses of administration and estate, inheritance and other taxes, except as specified in the statement, and that the assets of the estate have been distributed to the persons entitled; sent a copy of the statement to all distributees of the estate and to all creditors or other claimants of whom the personal representative is aware whose claims are neither paid nor barred; and furnished a full account in writing of the personal representative's administration to the distributees whose interests are affected thereby. UNIF. PROBATE CODE § 3-1003(a).

F. Liability as Legal Owner in Contract to Non-beneficiaries.

1. Trustee's Liability in Contract. Under the common law, when the trustee enters into a contract with a non-beneficiary, even though the trustee does so rightfully and on behalf of the trust, it nevertheless is the trustee's contract and not that of the trust. Thus, a suit at law upon the contract is against the trustee personally; judgment issues against the trustee individually; execution upon such a judgment cannot issue against the trust assets. *See* Bogert & Bogert, TRUSTS AND TRUSTEES § 712. Trust assets can be reached upon execution only through subrogation to whatever equitable rights of indemnity the trustee may have against the trust estate. *Id.* at § 716. In some jurisdictions, however, either by statute or on different theories of law, the trust assets may be reached directly. Under the Texas Trust Code, if a trustee makes a contract that is within his power as trustee, and a cause of action arises on the contract, a plaintiff can sue the trustee in his representative capacity, and a judgment rendered in favor of the plaintiff is collectible by execution against the trust property. TEX. PROP. CODE § 114.084. The Uniform Trust Code provides that except as otherwise provided in the contract, "a trustee is not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administering the trust if the trustee in the contract disclosed the fiduciary capacity." UNIF. TRUST CODE § 1010. The Uniform Trust Code generally protects a trustee who reveals the fiduciary relationship either by indicating a signature as trustee or by simply referring to the trust. It provides that a claim based on a contract entered into by a trustee in the trustee's fiduciary capacity may be asserted in a judicial proceeding against the trustee in the trustee's fiduciary capacity, whether or not the trustee is personally liable for the claim. *Id.* at § 1010(c).

2. Personal Representative's Liability in Contract. Under the common law, a personal representative has personal liability for a contract the personal representative enters into in his, her or its fiduciary capacity, unless the contract expressly excludes personal liability. UNIF. PROBATE CODE § 3-808 cmt. The Uniform Probate Code, however, would make the estate a "quasi-corporation" for such liabilities. *Id.* It provides that, unless otherwise provided in the contract, "a personal representative is not individually liable on a contract properly entered into in his fiduciary capacity in the course of administration of the estate unless he fails to reveal his representative capacity and identify the estate in the contract." UNIF. PROBATE CODE § 3-808(a). The Uniform Probate Code provides that claims based on contracts entered into by a personal representative in his, her, or its fiduciary capacity may be asserted against the estate by proceeding against the personal representative in the personal representative's fiduciary capacity, whether or not the personal representative is individually liable therefor. *Id.* at § 3-808(c) "Issues of liability as between the estate and the personal representative individually may be determined in a proceeding for accounting, surcharge or indemnification or other appropriate proceeding." *Id.* at § 3-808 (d).

G. Fiduciary's Liability as Legal Owner in Tort to Non-beneficiaries.

1. Trustee's Liability in Tort as Legal Owner. Under the common law, the trustee is as responsible for the torts which the trustee commits in the course of administering the trust as the trustee would be for those committed in the course of administering the trustee's own affairs. Thus, the trustee is personally liable to non-beneficiaries for any injury to them occasioned by a failure to keep the trust property in proper repair. *See* 3A Scott & Fratcher, THE LAW OF TRUSTS § 264. Moreover, if persons are employed on behalf of the trust, the trustee's personal liability for their torts is determined exactly as though they were employed for the trustee's own affairs. *See* RESTATEMENT (SECOND) OF TRUSTS § 264 cmt. b. This liability is personal to the trustee; execution therefore runs against the trustee irrespective of whether the trustee has a right to indemnity from the trust fund. *See* 3A Scott & Fratcher, THE LAW OF TRUSTS § 264. Under Texas law, a plaintiff may collect a tort judgment from the property of the trust for a tort committed by a trustee in the course of the administration of the trust if the court finds that (1) the trustee was properly engaged in a business activity for the trust and (a) the tort is a common incident of that activity or (b) neither the trustee nor an officer or employee of the trustee is guilty of negligence or intentional misconduct with regard to the liability, or (2) the value of the trust property is increased by the tort. TEX. PROP. CODE § 114.083.

2. Personal Representative's Liability in Tort as Legal Owner. Under the common law, the personal representative is "personally liable for obligations stemming from ownership or possession of the property (e.g., taxes) and for torts committed by servants employed in the management of the property." UNIF. PROBATE CODE § 3-808 cmt. The Uniform Probate Code, however, provides that a personal representative "is individually liable for obligations arising from ownership or control of the estate or for torts committed in the course of administration of the estate only if he is personally at fault." *Id.* at § 3-808(b). The Uniform Probate Code provides that claims based on torts committed in the course of estate administration may be asserted against the estate by proceeding against the personal representative in his fiduciary capacity, "whether or not the personal representative is individually liable therefor." *Id.* at § 3-808(c). The Uniform Probate Code further provides that "issues of liability as between the estate and the personal representative individually may be determined in a proceeding for accounting, surcharge or indemnification or other appropriate proceeding." *Id.* at § 3-808(d).

H. Power of Fiduciaries to Engage in Business.

1. Authority to Engage in Sole Proprietorships.

a. Trustees. Most state trust acts permit a trustee to operate a business, at least when the business was contributed to the trust. Section 113.008 of the Texas Trust Code provides that a trustee "may invest in, continue, or participate in the operation of any business or other investment in any form, including a sole proprietorship." TEX. PROP. CODE § 113.008. Section 737.402(2)(d) of the Florida Trust Act permits a trustee to "continue or participate in the operation of any business or other enterprise ...." FLA. STAT. ANN. § 737.402(2)(d).

b. Executors. Surprisingly, the executor of an estate does not have an inherent power to continue a decedent's business. Instead, the executor is normally charged with a duty to wind up the business. *See, e.g., Willis v. Sharp*, 113 N.Y. 586, 21 N.E. 705 (1889); *In re Wolf's Estate*, 87 N.Y.S.2d 327 (Surr. Ct. 1943). The rationale for this holding is that the continuation of the decedent's business often prolongs the administration of an estate and delays the payment of creditors, contrary to public policy that estates be promptly settled and distributed. An executor can be authorized to continue an ongoing business and to engage in new enterprises if the authority to do so is clearly and unambiguously expressed. *See, e.g., Burwell v. Mandeville's Executor*, 43 U.S. (2 How.) 560 (1844); *Willis v. Sharp*, 113 N.Y. 586, 21 N.E. 705 (1889); *Eufala Nat'l. Bank v. Manasses*, 124 Ala. 379, 27 So. 258 (1900). Even with express authorization, however, a court may construe the executor's authority narrowly, authorizing the executor to continue the business only for the purpose of winding it up or selling it as a going concern. *See Beck v. Beck*, 383 So.2d 268 (Fla. App. 1980). In some states, legislatures have enacted statutory authority enabling an executor to continue a decedent's trade or business. These authorizations are often quite limited. For example, § 238 of the Texas Probate Code authorizes an executor (with court approval in a dependent administration) to "carry on the operation" of a "farm, ranch, factory, or other business, or cause the same to be done, or rent the same, as shall appear to be for the best interest of the estate." TEX. PROB. CODE ANN. § 238. However, that section also provides that a business can be continued unless the business is "required to be sold at once for the payment of debts or other lawful purposes." *Id.* As a result, the statute appears to limit the executor's authority to continue a business when the estate is insolvent–i.e., when the business arguably must be "sold at once for the payment of debts." Section 53-7-6(5) of Georgia's revised 1998 Probate Code permits an executor to "continue the business of a decedent for 12 months following the qualification of the personal representative, after which the personal representative may petition for permission to continue the business under such terms and conditions as the probate court may specify." GA. CODE ANN. § 53-7-6(5) (1997). If the estate does not have sufficient liquidity to satisfy its debts, the decedent's creditors may have a right to insist that their claims be satisfied out of the property left by the decedent at his death, with the result that if the personal representative continues the business, he does so at his own financial risk. *See, e.g., In re Ruggles' Estate*, 275 Mich. 237, 266 N.W. 332 (1936); *American Surety Co. v. McGuire*, 103 N.Y.S. 753, 754 (Surr. 1907); *Willis v. Sharp*, 115 N.Y. 396, 22 N.E. 149 (1889).

2. Establishment of a New Business. Even in those states which authorize business continuations, there may not be statutory authority to undertake new business activities. For example, § 238 of the Texas Probate Code applies by its terms only to businesses the "estate owns...." As a result, the establishment of new businesses falls outside the scope of the statute. *See Lovenskiold v. Nueces Hotel Co.*, 208 S.W. 759 (Tex. App.–San Antonio 1919, *no writ*). Incorporating a pre-existing business or otherwise taking steps to insulate the personal representative and the estate's non-business assets from the risks associated with an ongoing enterprise will be prudent in many circumstances. Notwithstanding its prudence, some courts have declined to allow incorporation absent clear authority in the governing instrument. *See Randolph v. East Birmingham Land Co.*, 104 Ala. 355, 16 So. 126 (1983); *see also Trustee's Power to Exchange Trust Property for Shares of Corporation Organized to Hold the Property*, 20 ALR3d 841. *Cf. McCollum v. William McCollum Corp.*, 435 So. 204 (Ala. 1983).

a. Trustees. Most state trust acts permit a trustee to establish a business. For example, § 113.008 of the Texas Trust Code provides that a trustee "may invest in, continue, or participate in the operation of any business or other investment in any form, including a sole proprietorship, partnership, limited partnership, corporation, or association, and the trustee may effect any change in the organization of the business or enterprise." TEX. PROP. CODE § 113.008. This statute was added as a part of the Texas Trust Code effective January 1, 1984. No cases have interpreted this provision, but the statute clearly gives trustees the power, subject to any limitations imposed on the exercise of such power by their duties, to engage in partnerships and unincorporated businesses. *But see*

Port Arthur Trust Co. v. Muldrow, 291 S.W.2d 312 (Tex. 1956). In addition, § 114.085 of the Texas Trust Code provides language similar to Texas Probate Code § 238A by limiting third party liability for a trustee who "takes the place of a deceased partner in a general partnership in accordance with the articles of partnership" to the deceased partner's capital in the partnership and the trust funds held by the trustee. In addition, the statute requires a trustee who contracts to become a partner of a general partnership "in its capacity as trustee" to limit the trust's liability, "to the extent allowed by law," to the trust assets contributed to the partnership and the other trust assets under management by the trustee. TEX. PROP. CODE § 114.085(b).

b. Executors. An executor's authority to continue a "business" does not necessarily extend to partnerships. For example, § 238 of the Texas Probate Code applies to businesses the "estate owns," not to businesses in which the estate owns an interest. *Altgelt v. Alamo Nat. Bank*, 98 Tex. 252, 83 S.W. 6, 10-11 (1904); *Altgelt v. D. Sullivan & Co.*, 79 S.W. 333 Tex. App. 1903, *no writ*). However, § 238A of the Texas Probate Code, added in 1979, provides that if the decedent was a partner of a general partnership and "the articles of partnership provide that, on the death of a partner, his or her executor or other personal representative shall be entitled to the place of the deceased partner in the firm," the personal representative's liability to third parties, "to the extent allowed by law," shall be limited to decedent's capital in the partnership and the estate's assets held by the personal representative. TEX. PROB. CODE ANN. § 238A. The statute does not authorize an executor to become a successor general partner of a general partnership in which the decedent was a partner. Rather, it addresses the potential liability to third persons if the executor chooses to do so, and affirmatively states that an executor is not exonerated from liability for his own negligence. TEX. PROB. CODE § 238A. Moreover, the statute does not address either the authority to become, or the potential liability to third parties of an executor who contracts to become, a successor general partner when the partnership agreement does not expressly authorize or require the estate to succeed the decedent as a partner. The statute is silent on the impact of retaining a limited partnership interest, presumably because the Texas Business Organizations Code adequately limits the estate's potential liability to third parties to the extent of its investment in the limited partnership. TEX. BUS. ORG. CODE §153.102.

3. Authority of Fiduciaries to Become Partners. As a general rule, fiduciaries are not permitted to engage in partnership businesses. *White v. Sherman*, 168 Ill. 589, 48 N.E. 128 (Ill. 1807). Carrying on a partnership business has been characterized as "fundamentally alien" to the function of a trustee. *Hanson v. Birmingham*, 92 F. Supp. 33, 44 (N.D. Iowa 1950) app. dism'd 190 F.2d 206 (8th Cir.1951). Thus, absent statutory or testamentary authority to the contrary, a fiduciary who joins a partnership is bound individually as a partner and the estate or trust is not bound. *See Altgelt v. D. Sullivan & Co.*, 79 S.W. 333 (Tex. Civ. App. 1903, *no writ*). The Office of the U.S. Comptroller of the Currency ("OCC") has issued a ruling that a national bank subject to its supervision cannot retain or invest in a general or limited partnership unless its liability is limited by governing state law or authorized by the governing instrument. In the words of the ruling:

> As a general proposition under the common law of trusts, partnerships are not considered appropriate for fiduciary investments. As a general partner, a bank's liability is not limited to the principal of the particular account, unless otherwise provided by state law. In the capacity of limited partner, the bank usually would have no say in the management of the assets. Consequently, the OCC would object to a bank investing in general partnerships, unless its liability is limited by state law. In the case of investment in limited partnerships, the OCC would object unless such investments are specifically authorized by the governing instrument.

Comptroller's Handbook for National Trust Examiners, Op. No. 9.4050; *see also* G. Bogert, THE LAW OF TRUSTS AND TRUSTEES § 679 (Rev'd 2d ed., 2000 Supp.). A decedent or settlor can authorize his personal representative to succeed him as a partner of an existing partnership either by the will or trust agreement or in the partnership agreement. *Altgelt v. D. Sullivan & Co.*, 79 S.W. 333 (Tex. Civ. App. 1903, *no writ*); *Glaser v. Glaser*, 19 A.D.2d 354, 243 N.Y.S.2d 348 (1963) aff'd 14 N.Y.2d 895, 252 N.Y.S.2d 93, 200 N.E.2d 776 (1964). However, the scope of the fiduciary's authority often will be narrowly construed. For example, the authorization to continue a decedent's partnership business normally will be construed only as a power to leave in the partnership business the capital already invested at the time of death. *Burwell v. Mandeville's Executor*, 43 U.S. (2 How.) 560 (1844); *Accidental Oil Mills v. Tomlinson*, 8 S.W.2d 558 (Tex. Civ. App.–Austin 1928, *writ ref'd*); *Hake v. Dilworth*, 96 S.W.2d 121 (Tex. Civ. App.–Waco

1936, *writ dism'd*). Section 6 of the Uniform Partnership Act (UPA) defines a partnership as "an association of two or more persons to carry on as co owners of a business for profit." Section 2 of the UPA defines "person" to include "individuals, partnerships, corporations, and other associations." Because an "estate" is not a legal entity, some courts have held that an "estate" cannot become a partner of a partnership. *See Hanson v. Birmingham*, 92 F. Supp. 33 (N.D. Iowa 1950) app. dism'd 190 F.2d 206 (8th Cir. 1951); W.R. Rieman, *Trust Participation in a Partnership*, 2 HASTINGS L. J. 24 (1950) (criticizing *Hanson*). In some states, when a person dies owning an interest in a partnership, courts have required a dissolution and liquidation of the partnership in the absence of an agreement to the contrary. *See Fisher v. Fisher*, 250 F. Supp. 677 (D.C. Pa 1967) (applying Florida law). Texas has taken a more liberal view. Texas's Business Organization Code defines "person" to include a "corporation, organization, government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity" thereby suggesting that a personal representative or trustee is eligible to become a partner of either a general partnership or a limited partnership. TEX. BUS. ORG. CODE § 1.002(69-b); TEX. GOV'T. CODE § 311.005. Some commentators have noted that the Texas partnership law provides that, a "person," may become a general or limited partner unless it lacks capacity apart from the statute. TEX. BUS. ORG. CODE § 153.101(d). Because neither a trust nor an estate is a legal entity, despite the fact that each may be defined as a "person" eligible to become a partner under Texas partnership law, it would appear that the fiduciary, and not the "estate" or "trust" itself, is really the partner, albeit in his, her, or its representative capacity. *See Port Arthur Trust Company v. Muldrow*, 155 Tex. 612, 291 S.W.2d 312 (1956) (holding that a corporate trustee is a "person" eligible to be a limited partner). It is the author's experience that corporate fiduciaries will agree to hold limited partnership interests in trusts or estates, based upon state statutory authority that limits their liability to assets of the particular trust or estate.

4. Fiduciary Duties with Respect to Investment in Business. In analyzing any fiduciary transaction, it is important to remember that even though a fiduciary may possess the power to engage in certain conduct, he may be under a duty not to do so. For example, a trust agreement may authorize a trustee to acquire real estate as a trust investment, but the fiduciary's duty to invest prudently and exercise reasonable care, skill and caution will prevent the fiduciary from making hazardous or speculative real estate investments. Even if the will or trust agreement purports to grant the fiduciary broad discretion, the trustee must not act outside the bounds of reasonable judgment. *Thorman v. Carr*, 408 S.W.2d 259, 260 (Tex. Civ. App.–San Antonio 1966) *aff'd per curium*, 412 S.W.2d 45 (Tex. 1967).

a. Trustees. Courts and legislatures are endeavoring to modernize their trustee investor standards to address modern portfolio management theory, which recognizes that it may be appropriate in some portfolios to include some higher risk investments that have greater opportunity for higher returns. Thus, a prudent investor might make an investment of a small percentage of the trust estate in an asset that might not be suitable if it comprised the entire trust estate (or a large portion of the trust estate). Likewise, an otherwise prudent investment might not be prudent in the context of the entire trust. For example, a prudent person might invest in real estate if the projected returns justify the investment. If the trust estate is already comprised primarily of real estate, however, this purchase may violate the prudent investor standard because of the lack of diversification. Likewise, certificates of deposit may be prudent to hold in a portfolio, but because they have no growth potential and may be eroded by inflation, it may be imprudent to hold a major portion of the trust estate in these investments. See UNIF. PRUDENT INVESTOR ACT § 2 cmt. The primary objective of the prudent investor rule is to conserve the principal of the trust. *See, e.g., Republic Nat'l Bank & Trust Co. v. Bruce*, 105 S.W.2d 882 (Tex. Comm'n App. 1937, opinion adopted); *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Bocock*, 247 F. Supp. 373 (S. D. Tex. 1965). An ordinary prudent person may incur risk with the hope of capital appreciation. A trustee may not have as much freedom. Some courts suggest that a trustee can take only those risks taken by an ordinary prudent person charged with investing the funds of others, bearing in mind that the primary objective is preservation, not accumulation. *See First Nat. Bank of Kansas City v. Hyde*, 363 S.W.2d 647 (Mo. 1963); G. Bogert, THE LAW OF TRUSTS AND TRUSTEES § 612 (Rev'd 2d ed., 1982). To "invest" means to place capital so that it will be safe and yield a profit; to "speculate" is not safe and means to subject capital to risk and uncertainty depending on market fluctuations, more or less remote in time, the probable results of which cannot be determined. *Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Bocock*, 247 F. Supp. 373 (S. D. Tex. 1965). Perhaps the Texas Trust Code can be read to relax the "safety" requirement since the "probable increase in value" of an investment is now a relevant factor. If the trustee's investment in a business proves to be unsuccessful, however, one might expect that with the benefit of hindsight, a jury will characterize the investment as "unsafe" or "speculative." Courts have approved the rule set forth in RESTATEMENT (SECOND) OF TRUSTS § 228 (1959) imposing on trustees a duty to diversify unless under the circumstances it is prudent not to do so. *Jewett v. Capital Nat. Bank of Austin*, 618 S.W.2d 109 (Tex. Civ. App.–Waco 1981, *writ ref'd n.r.e.*); *See Duty of Trustee to Diversify Investments, and Liability for Failure to Do So*, 24 A.L.R.3d 730 (1969). This rule has been codified in Texas. *See* TEX. PROP. CODE § 117.005. When an interest in a closely held business or partnership is an important asset of a trust, the trustee should consider whether the benefits of diversification outweigh the potential benefits of retaining the business interest. Most trust agreements giving trustees broad investment powers only expand the types of investments from which the trustee may select, and do not relieve the trustee of the duty to use diligence and care in selecting and disposing of investments. *See InterFirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882 (Tex. App.–Texarkana 1987, *no writ*). The grant of broad powers does not protect the trustee from liability for imprudently exercising those powers, and courts generally do not construe trust instruments to authorize investments in speculative enterprises. Bogert & Bogert, TRUSTS AND TRUSTEES § 705 (Rev'd 2d ed., 1984); Committee Report, 13 REAL PROP., PROB. & TRUST J. 650 (1978). It is important for the trustee to document its basis for making these decisions.

b. Personal Representatives. An executor has been held to be primarily a liquidator and conservator of assets, not an investor. As a result, investing in a new business has been held to be inappropriate absent authority to do so under the decedent's will. *Lovenskiold v. Nueces Hotel Co.*, 208 S.W. 759 (Tex. App.–San Antonio 1919, *no writ*). In contrast, continuing a decedent's business for purposes of liquidation or sale as a going concern is generally consistent with an executor's limited duties. As noted above, the Uniform Prudent Investor Act applies only to trustee, and *not to executors*. UNIF. PRUDENT INVESTOR ACT, Prefatory Note: Other Fiduciary Relationships. Continuing a decedent's business for other purposes–i.e., for the "best interests" of an estate–may not meet the "prudent investor" standard governing trustees (discussed above), much less the more restrictive investment standards typically applied to personal representatives charged with more limited duties. *See, e.g., Penn v. Fogler*, 182 Ill. 76, 55 N.E. 192 (1899); *In re Salz*, 80 A.D.2d 769, 436 N.Y.S.2d 713 (1981). "Unlike a trustee of a trust, a personal representative ordinarily has no power to invest funds belonging to the estate . . .. Of course, if the estate consists of liquid funds which will not be spent or distributed in the near future, the personal representative should invest the funds in secure investments such as savings accounts, certificates of deposit or the like." C. Saunders, TEXAS ESTATE ADMINISTRATION § 13.12 (1975). Nevertheless, § 238 of the Texas Probate Code applies a "best interests" of the estate standard to an executor's determination to continue a decedent's business.

VI. DISPOSITIVE ISSUES.

A. Lapse and Application of Anti-Lapse Statutes. At common law, an interest passing to a trust beneficiary who predeceased the testator lapsed unless the instrument provided to the contrary. *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS § 112 cmt. f. Most states now have statutory anti-lapse rules that preserve dispositions under a will if the intended beneficiary predeceases the testator, though these rules usually apply only if the predeceasing beneficiary is related to the decedent in a manner described in the statute. For example, in Texas, if a devisee who is a descendant of the testator or a descendant of a testator's parent fails to survive the testator, the descendants of the devisee who survive the testator by 120 hours take the devised property in place of the devisee. TEX. PROP. CODE § 68. The 1990 revision to the Uniform Probate Code extends the anti-lapse rules to revocable trusts. Section 2-707 of the 1990 UPC provides that the interest of a trust beneficiary who dies before the interest becomes possessory will, absent specific provisions in the trust instrument, pass to that beneficiary's surviving descendants. Several states have statutorily extended their anti-lapse rules to dispositions under a trust. *See, e.g.*, Fla. Stat. ch. 732.603; Tenn. Code Ann. § 32-3-105. *See also* Blaustein & Ward, *The Future of Revocable Intervivos Trusts: Are the Lines Between Wills and Trusts Blurring?* 9 PROB. & PROP. 46, 49 (Sept./Oct. 1995). Texas, however, has not done so. Absent statutory authority, most courts have refused to extend to revocable trust dispositions state anti-lapse statutes that by their terms refer to dispositions of decedents' estates. *See, e.g., In re Capocy's Est.*, 430 N.E.2d 1131 (Ill. Ct. App. 1981); *Hinds v. McNair*, 413 N.E.2d 586 (Ind. Ct. App. 1980); *Detroit Bank & Trust Co. v. Grout*, 289 N.W.2d 898 (Mich. Ct. App. 1980); *May v. Safer*, 208 N.W.2d 619 (Mich. Ct. App. 1973). Some courts have, however, avoided the problem of lapse by concluding that the beneficiary's interest was vested as soon as the trust was created, and the death of the beneficiary before the settlor's death did not deprive the beneficiary of the ability to dispose of his or her interest in the trust. *See First Nat'l Bank of Cincinnati v. Tenney*, Ohio St. 513, 60 Ohio Op. 481, 138 N.E.2d 15 (1956); *Detroit Bank & Trust Co. v. Grout*, 289 N.W.2d 898 (Mich. Ct. App. 1980). There are, however, at least two cases applying to revocable trusts state anti-lapse statutes that, on their face, related only to dispositions under a will. In *In re Button's Est.*, 79 Wash. 2d 849, 490 P.2d 731 (1971), the Supreme Court of Washington held that the Washington anti-lapse statute applied to revocable trusts. In *Dollar Sav. & Trust Co. of Youngstown v. Turner*, 39 Ohio St. 3d 182, 529 N.E.2d 1261 (1988) the Ohio Supreme Court adopted a similar analysis and applied the Ohio anti-lapse statute to a revocable trust.

B. Ademption. Generally, a specific bequest or devise in a will of property that the testator owns on the date the will is executed is void under the doctrine of ademption by extinction if the property is not owned by the testator on the date of death. *See Shriner's Hosp. for Crippled Children v. Stahl*, 610 S.W.2d 147, 150 (Tex. 1980). *See, also*, RESTATEMENT (THIRD) OF PROP.: WILLS & DONATIVE TRANSFERS § 5.2 (1998); UNIF. PROBATE CODE § 2-606 (1990). This doctrine has traditionally been limited to the construction of wills, but it was extended to dispositions under a revocable trust in *Wasserman v. Cohen*. 414 Mass. 172, 606 N.E.2d 901 (1993), where the court noted, "The subsidiary rules [of wills] are the product of centuries of legal experience in attempting to discern transferors' wishes and suppress litigation. These rules should be treated presumptively correct for will substitutes as well as for wills." *Id.* at 768, 473 N.E.2d 1084, quoting Langbien, *The Nonprobate Revolution and the Future of the Law of Succession*, 97 HARV. L. REV. 1108, 1136-1137 (1984). However, this decision appears to be the only case extending the rule to revocable trusts. The logic applied by the Supreme Judicial Court of Massachusetts was sound, but drafters should address questions directly in drafting for the treatment of assets not owned by the trustee on the date of the settlor's death, rather than relying on the doctrine of ademption by extinction.

C. Medicaid Eligibility. The use of a revocable trust rather than a will to leave assets to an incapacitated individual may affect the individual's eligibility for benefits under a Medicaid program. Medicaid provides cash payments for the aged, blind, or disabled, but it is available only for individuals who have no more than a very modest amount of income or personal assets. 42 USC §§ 1396-1396p. The vast majority of states make Medicaid benefits available to all persons who are "categorically needy," including aged, blind, or disabled persons who meet the financial requirements for Supplemental Security Income (SSI) benefits. 42 USC § 1396a. States may vary the amount of available resources that may be retained by a Medicaid recipient, but assets that are excluded from the definition of "available resources" under federal law cannot be treated as available resources under state law. *See* 42 USC § 1396a(a)(10)(C)(i). Medicaid benefits are not paid until the individual has expended all assets owned by him or her, with certain relatively modest exemptions, which include, for example, the applicant's principal residence, up to $2,000 ($3,000 for a married couple) in value of household goods and personal effects, one automobile used as necessary transportation for essential daily activities, business property essential for the applicant's self-support, burial plots, irrevocable funeral policies, savings up to $2,500 designated as a funeral or burial fund, and up to $2,500 in life insurance (face amount). *See* 42 USC § 1382b(a).

1. Self-Settled Revocable Trusts. The assets of a revocable trust are treated as assets of the trust's settlor during his or her lifetime. As such, the corpus of the trust is treated as applicable resources of the settlor, payments from the trust to or for the benefit of any individual are treated as income of that individual, and any other payments from the trust are treated as dispositions by the settlor for purposes of the 36-month eligibility rule. 42 USC § 1396p(c)(1). In fact, for trust payments, the look-back period is extended to 60 months. *Id.*

2. Revocable Trusts after the Settlor's Death. Revocable trusts create two significant potential problems in qualifying a beneficiary for Medicaid benefits after the settlor dies. First, under the Medicaid rules, the assets of many types of trusts established by someone other than the Medicaid applicant can be counted as available resources of the applicant. Second, assets are treated as resources for Medicaid purposes if they are owned (or deemed owned) by the disabled individual, or if the disabled individual has transferred the assets outright and without adequate consideration within 36 months before the date on which Medicaid eligibility is first determined. 42 USC § 1396p(c)(1). *See generally* Esperti & Peterson, *Proper Drafting and Planning for the Use of Revocable Trusts*, 21 COLO. LAW. 2565, 2566-2567 (Dec. 1992); Kruse, *Twenty-Six Reasons for Caution in Using Revocable Trusts*, 21 COLO. LAW. 1131, 1132 (June 1992). For transfers involving trusts after February 8, 2006, the look-back period is extended from 36 to 60 months. 42 USC § 1396p(c)(1). At least two courts have held that the termination of a disabled beneficiary's interest in a settlor's revocable trust upon the death of the settlor may be a disqualifying transfer for this purpose. *See Canter v. Comm'r of Public Welfare*, 423 Mass. 425, 668 N.E.2d 783 (1996); *Bezzini v. Dep't of Soc. Services*, 49 Conn. App. 432, 715 A.2d 791 (1998). Thus, the choice of a revocable trust instead of a will to implement an estate plan can result in the disqualification of a surviving beneficiary for Medicaid eligibility unless scrupulous attention to the technical Medicaid eligibility rules are addressed.

D. Selecting the Situs of Asset Administration. A revocable trust can be used to enable the settlor to select the state or country under whose laws the settlor wishes to dispose of one or all of his or her assets. The rules by which the state assumes jurisdiction over various aspects of trust administration, construction, and the rights of beneficiaries depend on whether the trust corpus is real or personal property. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 276 (1971). Generally, the laws of the jurisdiction in which the trust is otherwise administered determine issues relating to the *administration* of a trust holding either tangible or intangible personal property. *Id.* The settlor's designation in the governing instrument of such a jurisdiction generally controls. *See also Matter of Hecht*, 54 B.R. 379 (Bankr. S.D.N.Y. 1985); *Nat'l Shawmut Bank of Boston v. Cumming*, 91 N.E.2d 337 (Mass. 1950); *Matter of Moore*, 129 Misc. 2d 639, 493 N.Y.S.2d 924 (N.Y. Sup. Ct. 1985) Thus, courts of states other than that of the trust administration should decline to exercise otherwise legitimate jurisdiction over an inter vivos trust if exercising jurisdiction would unduly interfere with the control of administration by the courts of the state of administration. *See, e.g., Baltimore Nat'l Bank v. Cent. Pub. Util. Corp.*, 26 Del. Ch. 295, 28 A.2d 244 (Del. Ch. 1942); *Kitchen v. New York Trust Co.*, 292 Ky. 706, 168 S.W.2d 5 (1943); *Staley v. Safe Deposit & Trust Co. of Baltimore*, 189 Md. 447, 56 A.2d 144 (1947); *David v. Atlantic County Soc'y for Prevention of Cruelty to Animals*, 129 N.J. Eq. 501, 19 A.2d 896 (N.J. Ch. 1941); *In re Berry*, 178 A.D. 144, 164 N.Y.S. 990 (1917); *Lines v. Lines*, 142 Pa. 149, 21 A. 809 (1891).

As to trusts of interests in *land*, however, the law of the situs of the land is more important. The *administration* and *validity* of a trust in land usually depend on the law of the state in which the land is situated, even if the trustees are domiciled in a different state. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 276 (1971). A court of a non-situs state may exercise jurisdiction if it does not unduly interfere with control by the courts of the situs. *Id.* cmt. b. Similarly, the law of the situs has not always controlled issues of *construction*. While courts generally apply the law of the situs, other courts, in certain cases, have applied the law designated by the settlor in construing a trust holding real estate. *Compare Veach v. Veach*, 205 Ga. 185, 53 S.E.2d 98 (1949) *with Greenwood v. Page*, 138 F.2d 921 (D.C. Cir. 1943). Thus, the settlor should be able to select the situs for the administration of a revocable trust holding personal property, for construing the trust (even if it holds land), and for determining the validity of a trust holding personal property, by stating the choice of situs in the instrument and naming at least one trustee in that jurisdiction to administer the trust assets. A settlor who wishes to designate a particular situs for the administration of real property by a revocable trust should, if practicable, transfer the real estate to a corporation, partnership, or limited liability company (LLC), because stock, partnership interests, and LLC interests are considered personal property even when the underlying assets are real property. The settlor can then transfer the stock, partnership interest, or LLC interest to the revocable trust, the terms of which would be governed more clearly by the law of the designated situs.

VII. TAX ISSUES ASSOCIATED WITH REVOCABLE TRUSTS

A. Federal Income Tax Issues. While much popular press is devoted to the advantages of a revocable trust over an estate, after a settlor's death, there can be several disadvantages as well. For decades, trusts and estates have been subject to an essentially uniform set of federal income tax rules. Until 1997, however, there were more than a dozen areas in which small differences remained between the income taxation of trusts and estates. Congress has largely sought to eliminate these differences, in some cases by applying rules to estates (such as the separate share rule of § 663(c)) that were formerly applicable only to trusts. In large measure, however, the disparities were eliminated by allowing certain post-death revocable trusts to elect to be treated as estates. This election, discussed in Section VII.A. 11. below, ameliorates many of the income tax disadvantages other faced by trusts. It is important to understand, however, that if the trust is unable or fails to make the election to be treated as an estate, these disadvantages remain. They include the following:

1. Taxable Year. While a revocable trust may be ignored for federal income tax purposes during the settlor's lifetime, it becomes a separate taxable entity upon the death of the settlor because the power to revoke terminates with the settlor's death. Rev. Rul. 75-267, 1975-2 C.B. 254. Section 644(a) requires that all trusts adopt a calendar taxable year. Estates, however, may adopt either a calendar year or a fiscal year. IRC §§ 443, 7701(a)(1), (14). An estate, therefore, can choose whatever fiscal year best matches available income and deductions, enabling the executor to defer the tax that calendar-year beneficiaries must pay on certain distributions from the estate. Section 662(c) provides that, if the taxable year of a beneficiary is different from that of an estate, the amount to be included in the gross income of the beneficiary is based on the distributable net income (DNI) of the estate and the amounts properly paid, credited, or required to be distributed to the beneficiary during any taxable year or years of the estate ending within or with his or her taxable year. Therefore, if an estate distributes to a beneficiary income that is not required to be distributed under the instrument or state law, the taxable year in which the beneficiary must report the income is not necessarily the year in which the beneficiary receives it but, instead, depends on the relationship between the taxable years of the estate and beneficiary.

Example: Assume that D died on June 20, 2001, and D's estate adopts a fiscal year ending Jan. 31. The estate has only one beneficiary, B, an individual with a calendar taxable year. On Feb. 2, 2002, the executor paid B $10,000 from the estate's DNI. The distribution was made during the estate's taxable year ending Jan. 31, 2003. Thus, it is includible in B's taxable year within which that date occurs, i.e., the calendar year ending Dec. 31, 2003. Had the estate picked a calendar taxable year, the distribution would have been includible in B's taxable year ending Dec. 31, 2002. Thus, B receives an additional year's deferral of paying the tax on the distribution.

The staggered fiscal year option for an estate has obvious appeal, but it can occasionally create problems for the beneficiaries. For example, if the ultimate income beneficiary is the surviving spouse, consideration must be given to bringing the taxation of this income into a taxable year of the spouse ending not more than two years after the decedent's death so that the spouse can use the joint return filing rates. These rates may be lower than the rates for single persons or heads of households. A surviving spouse may use the joint rates for up to two years following the first spouse's death if the surviving spouse has a dependent child (son, daughter, stepson, stepdaughter) living with him or her. Another drawback to the staggered taxable year option is that individuals are rarely able to comprehend the concept of paying taxes on money they received in earlier years and which they will, almost invariably, have already spent. Regardless of how often an advisor explains to a client that money received in one year will be taxed in a later year, the client may have forgotten the explanation and thus may be upset at having to pay more tax than anticipated.

2. Adjusted Basis of Trust Assets. A revocable trust acquires an adjusted basis in assets (with certain specific exceptions) held on the date of the settlor's death equal to the asset's fair market value (or other estate tax value, such as the reduced value under Section 2032A) on the date of the settlor's death or, if elected by the executor, equal to the alternate valuation date value. IRC § 1014(b); *see also* PLR 8904046. If the trust acquires assets after the settlor's death, the ordinary rules governing basis determination control; thus, the income tax basis of those assets depends on the method by which they are acquired. Section 1014(e) states that the ordinary basis adjustment rules of § 1014(a) do not apply with respect to appreciated property that was acquired by the decedent by gift within one year before the decedent's death, if that property is acquired from the decedent by, or passes from the decedent to, the donor of such property (or the donor's spouse), either directly or indirectly. Section 1014(e) gives the person who receives the property at the decedent's death (i.e., the original donor), or that person's spouse, an adjusted basis equal to the adjusted basis in the hands of the decedent immediately before death, thus denying the step-up in basis. The denial of a stepped-up basis applies only to the extent that the donor-recipient or the donor-recipient's spouse is entitled to receive the value of the appreciated property. *See* H.R. Rep. No. 97-201, at 188 (1981), reprinted at 1981-2 C.B. 352, 391. The IRS has applied this rule to revocable trusts (the "tax-basis trust") designed to achieve inclusion in the gross estate of the first of two settlors to die of both the property contributed by that settlor to the revocable trust and that contributed by the surviving settlor. *See* Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* ¶ 4.07; Fletcher, *Tax Basis Revocable Trusts*, 63 Tax Notes 1183 (5/30/94); Fletcher & Zaritsky, *Tax Basis Revocable Trusts: How They Work After Technical Advice Memorandum 9308002*, 35 TAX MGMT. MEMO. 319 (1994). The potential benefits of the tax-basis trust are quite significant, but the hostile attitude of the IRS and the difficulty inherent in drafting such an instrument limit its utility. In community property states, the ability to obtain an adjusted basis at the first spouse's death is straightforward. IRC § 1014(b)(6). In order to preserve this benefit, caution should be taken when transferring community property assets to the trust in order to insure that a partition of the assets does not occur.

3. Personal Exemption. A revocable trust that becomes irrevocable upon a settlor's death also becomes a separate taxpayer and receives its own personal exemption. A revocable trust that becomes a simple trust (one that is required to distribute all of its income currently and that cannot distribute any principal or charitable amounts during the year) receives a $300 personal exemption when it becomes irrevocable. IRC § 642(b)(2)(B). A revocable trust that becomes a complex trust (one that may accumulate or distribute all of its income currently and may make principal distributions or, possibly, charitable distributions) receives a $100 personal exemption. IRC § 642(b)(2)(A). An estate, on the other hand, receives a $600 personal exemption. IRC § 642(b)(1).

4. Estimated Income Taxes. A decedent's estate does not need to make estimated income tax payments for the first two years after the decedent's death. IRC § 6654(l)(2)(A). A revocable trust is required to file estimated income tax returns and to pay estimated income taxes, unless the trust is wholly a grantor trust, and the residue of settlor's estate pours over to the trust or no will is admitted to probate and the trust is primarily responsible for paying the debts, taxes, and expenses of the estate. IRC § 6654(l)(2)(B). If the trust meets these two conditions, no estimated taxes are due for any tax period before the date two years after the date of death (the same rule applicable to estates). IRC § 6654(l)(2).

5. Recognition of Loss on Distribution in Satisfaction of Pecuniary Bequest. Section 267 states that a trust may not recognize a loss on a sale or exchange of property between the trust and a beneficiary. IRC §§ 267(a)(1), (b)(6). The distribution of property in satisfaction of a pecuniary bequest (e.g., a pecuniary formula marital deduction bequest) is treated as a sale for this purpose. Treas. Reg. § 1.661(a)-2(f). Thus, the trustee of a revocable trust who, after the settlor's death, distributes property that has an adjusted basis in excess of its fair market value, in satisfaction of a pecuniary bequest, cannot deduct the realized loss. However, the beneficiary's adjusted basis in the property will be reduced to the fair market value of the distributed property. Treas. Reg. § 1.661(a)-2(f)(3). Section 267(b)(13) added in 1997, states that an executor cannot deduct any loss realized on a sale or exchange of property to a beneficiary of the estate, "except in the case of a sale or exchange in satisfaction of a pecuniary bequest." IRC § 267(b)(13). Therefore, an estate can recognize a loss on the distribution of such property to a beneficiary in satisfaction of a pecuniary bequest, but a revocable trust cannot. A revocable trust that has property with a basis in excess of its fair market value could, of course, sell the property to an unrelated third party, recognize a deductible loss, and then distribute the cash to the beneficiary in satisfaction of the pecuniary amount. Such a transaction would generate a recognized loss and put the beneficiary in the same tax position as if the property had been distributed in kind.

6. Charitable "Set Asides". An estate receives an income tax deduction under § 642(c) for all amounts paid to or irrevocably set aside for qualified charities. A revocable trust after the settlor's death, however, can deduct only amounts actually paid to qualified charities; a trust receives no deduction for amounts set aside for qualifying charities. IRC § 642(c)(2). (Note, however, that trusts created before Oct. 10, 1969 are eligible for deductions for amounts permanently set-aside for qualifying charities, including recognized capital gains, when the set-asides are required by the terms of the governing instrument.) Unless the trust makes an election under § 645 (discussed below), the loss of a charitable set-aside can be a serious issue if a charity is the residuary beneficiary of a revocable trust after the settlor's death. Unlike an estate, any gains realized during the trust's administration (after the settlor's death) cannot be deducted when they are recognized, but rather only when they are actually distributed to the charity. IRC § 642(c)(1).

7. Consenting to a Joint Return with the Settlor's Surviving Spouse. Section 6013(a)(3) permits an "executor" to file a joint income tax return with the decedent's surviving spouse for the year in which the decedent died. This option may be helpful in minimizing total income taxes when the decedent had significantly more taxable income than the surviving spouse. There may be no executor, however, if all of a decedent's assets are held in a funded revocable trust. For purposes of consenting to the filing of a joint income tax return, Treasury Regulation § 1.6013-4(c) states that an executor must be an individual appointed to administer the decedent's estate. The trustee of a funded revocable trust is not the executor for this purpose. *Compare* IRC § 2203 (definition of executor for estate tax purposes includes "any person in actual or constructive possession of any property of the decedent") *with* Treas. Reg. § 1.6013-4(c) ("executor" or "administrator" for purposes of filing a joint return "means the person who is actually appointed to such office and not a person who is merely in charge of the property of the decedent"). Two approaches can be taken regarding the § 6013(a)(3) election when no executor is appointed. First, depending on state law, the appropriate court can be petitioned to appoint an executor or administrator, even in the absence of a significant probate estate. Absent any property, the trust agreement could authorize the trustee to distribute assets to the estate (sometimes called a "pour-back"). Alternatively, the surviving spouse can file the joint return himself or herself; unless a subsequently appointed executor renounces the joint filing within one year of the filing date (including extensions), the return stands as filed. *See* IRC § 6013(a)(3); Treas. Reg. § 1.6013-1(d)(5). This approach does not appear to be available, however, if the surviving spouse dies before filing the return.

8. Series E and EE U.S. Savings Bonds. Interest on series E or EE U.S. savings bonds is normally taxed to the bondholder only upon redemption, unless the bondholder makes an annual election to report the income currently under § 454(a). In Revenue Ruling. 79-409, the IRS stated that an executor can make this election on the decedent's final return with respect to bonds that the decedent transferred to a revocable trust during the decedent's life. The executor was allowed to make the election even though the bonds continued to be held in the trust following the decedent's death. The IRS also stated that the executor, rather than the trustee, had to make the election, because the executor, not the trustee, had the obligation to file the final income tax return for the decedent, and it was on this return that the income would be reported. Rev. Rul. 79-409, 1979-2 C.B. 208.

9. S Corporation Stock. A revocable trust ceases to be a qualified subpart E trust when the settlor dies, and may therefore cease to be an eligible S corporation shareholder. IRC § 1361(c)(2)(A)(i).

a. Eligibility. The S corporation rules, however, provide that a revocable trust may continue to hold S corporation shares for two years without causing a termination of the S corporation election. IRC § 1361(c)(2)(A)(ii); Treas. Reg. § 1.1361-1(h)(1)(ii). The settlor's estate, in this situation, becomes the shareholder of the stock held by the trust for purposes of meeting the S corporation qualification requirements. IRC § 1361(c)(2)(B)(ii). Before amendment by the Small Business Job Protection Act of 1996, P.L. 104-188, § 1303, § 1361(c)(2)(A)(ii) required the entire trust corpus to be includible in the deemed owner's gross estate to qualify for the two-year period. Final regulations issued in 2003 deleted this requirement. The 2003 final regulations also clarified that, if the revocable trust is a "qualified revocable trust" (QRT) and the trustee and executor of the decedent's estate make a § 645 election (discussed below), the two-year period begins to run when the S corporation stock is transferred from the QRT to a new trust during the election period, or when the stock is deemed distributed to a new trust at the end of the election period. Treas. Reg. § 1.1361-1(h)(1)(iv)(B). Treasury Regulation § 1.1361-1(h)(1)(iv)(B) states that a testamentary trust includes a trust that receives S corporation stock from an electing QRT pursuant to the terms of the electing QRT. If the beneficiaries of the revocable trust (including any successor trusts) do not qualify as S corporation shareholders, two years may be a relatively short time within which to bring the trust's share holdings into conformity with the S corporation rules. There are several approaches a trustee may take. The first, and sometimes most obvious, is to distribute the shares to the individual beneficiaries, removing the trust as a shareholder. (Note that the maximum number of shareholders increased to 100 for taxable years beginning after December 31, 2004, pursuant to the 2004 American Jobs Creation Act, P.L. 108-357, § 232). Another option is for the trustee to sell the S corporation shares to another individual or qualifying trust. The trustee may, however, have difficulty finding a buyer for shares of a closely held corporation, or a sale may prejudice the position of beneficiaries who are already minority shareholders hoping to increase their interests in the corporation.

b. Allocation of Final Year Income. If the S corporation stock was held by a revocable trust prior to death, there are two methods of allocating the S corporation items between the decedent and the trust in the year of death. Under the general rule, the items of S corporation income, loss, deduction, and credit are first allocated equally to each day of the year, and then the daily amounts are allocated to the shareholders based on the number of shares they held on each day during the year. IRC § 1377(a)(1). Under the second option, with the agreement of the decedent and the trust as the "affected shareholders," the corporation may elect to divide its taxable year into two portions, the first ending on the date of the shareholder's death and the second ending on the usual year-end date. IRC § 1377(a)(2); Treas. Reg. § 1.1377-1(b)(2). The items of income, loss, deduction and credit are then allocated to each of these periods, using the corporation's normal method of accounting. The items allocated to the first period are then reported on the decedent's final return, while the items for the second period are allocated to the trust. Treas. Reg. § 1.1377-1(b)(1)-(3).

c. Successor Post-Death Trusts. The trustee may be able to continue to hold the shares if the trust is a "qualified subchapter S trust" (QSST) or an "electing small business trust" (ESBT). IRC §§ 1361(d), (e). Generally, a QSST can have only one beneficiary at any one time, and that beneficiary must have an income interest for life or until termination of the trust, whichever occurs earlier. Also, any principal distributions made by the trust must be made only to the income beneficiary during his or her life. If the trust terminates during the beneficiary's life, then all of its assets must be distributed to that beneficiary. Finally, the beneficiary, or his or her legal representative, must elect to be taxed as if he or she were the owner of the trust under § 678, and must also be a U.S. citizen or resident. IRC § 1361(d). To qualify as an ESBT, the trust must have only individuals, estates and qualified charities as beneficiaries. IRC § 1361(e)(1)(A)(i). In addition, the trust must not have acquired its interest in the stock by purchase. IRC § 1361(e)(1)(A)(ii). Of course, a revocable trust can qualify as an ESBT after the settlor's death because the trust's beneficiaries will have acquired their interests by bequest. If a valid ESBT election is made, the continuation of the trust will provide continuity of management and, unlike a QSST, flexibility in sprinkling distributions among beneficiaries. Disadvantages of an ESBT are that all of its S corporation income will be taxed at the highest marginal income tax rate and the trust will not be allowed a distribution deduction. IRC §§ 641(c)(2)(A), 641(c)(2)(C). Care must be taken, however, to ensure that the number of potential trust beneficiaries does not cause the S corporation to exceed the shareholder limit, because each "potential current beneficiary" is treated as a shareholder. IRC § 1361(e).

10. Passive Losses. The Tax Reform Act of 1986 imposed a series of passive loss rules disallowing the current deduction of net losses from passive activities in which the taxpayer (including an estate or trust) has an interest but does not materially participate. Under the passive loss rules, the use of a grantor trust to hold passive loss property can have adverse consequences after the settlor's death. Under § 469(i), up to $25,000 of passive losses attributable to real estate rental activities in which an individual taxpayer actively participates is deductible. The $25,000 figure is reduced as a taxpayer's income exceeds $100,000. IRC § 469(i)(3)(A). On the death of an individual taxpayer, his or her estate is deemed under § 469(i)(4) to have actively participated in any such real estate activities for those taxable years of the estate ending within two years of the decedent's death. Thus, the estate will be able to continue deducting passive losses. No similar treatment is provided for revocable trusts, unless an election is made under § 645 to be treated as part of the estate (as discussed below). Therefore, funded revocable trusts may be somewhat less suitable for holding the rental real estate of certain taxpayers. The distribution of passive loss property from a revocable trust following the settlor's death will also have income tax implications. Section 469(j)(6) provides that, when an estate or trust distributes its entire interest in a passive activity asset to its beneficiary, the basis in the asset immediately before distribution is increased by the amount of disallowed passive losses allocable to the activity. As a result, such losses will not allowable as a deduction in any taxable year. IRC § 469(j)(6)(B). The increase in basis will, however, have the effect of decreasing any gain (or increasing any loss) on a later disposition of the activity.

11. Section 645 Election to Treat a Revocable Trust as Part of the Settlor's Estate. Congress recognized that, although revocable trusts may offer non-tax advantages over wills for estate planning, differences in the federal income tax treatment of revocable trusts and estates could discourage individuals from using trusts where they might otherwise be appropriate or efficient. Section 645, added by the Taxpayer Relief Act of 1997, allows the trustee of a decedent's "qualified revocable trust" and the executor of the decedent's estate to make an irrevocable election to treat the trust as part of the decedent's estate (and not as a separate trust) for federal income tax purposes. This elective treatment is available for any trust (or portion thereof) that was treated under § 676 as owned by the decedent by reason of a power in the decedent (without applying the § 672(e) rule attributing the powers of the settlor's spouse to the settlor). IRC § 645(b)(1). The election, made on Form 8855, Election To Treat a Qualified Revocable Trust as Part of an Estate, must be made by both the trustee and the executor of the decedent's estate (if one is appointed). IRC § 645(a). Once made, the election is irrevocable. IRC § 645(c). The election is effective from the date of the decedent's death until the later of two years after his or her death (if no estate tax return is required) or until six months after the final determination of estate tax liability (if an estate tax return is required). IRC §§ 645(a), (b)(2), *see also* Chisolm & Finestone, *New Section 645 Election*, 25 ACTEC NOTES 86 (Summer 1999); Fee, *Electing to Treat a Revocable Trust as Part of the Estate*, 26 EST. PLAN. 118 (Mar./Apr. 1999). The election has several significant income tax effects for the revocable trust and estate. First, and probably most importantly, it eliminates the need for separate income tax returns for the trust and the estate. Second, the trust may claim an income tax charitable deduction for amounts permanently set aside for charitable purposes, as well as for amounts paid to charities. Third, the active-participation requirement in the passive loss rules under § 469 would be waived for the revocable trust, as it is for estates, for two years after the owner's death. Fourth, the trust can qualify for amortization of reforestation expenditures under § 194.

a. Qualified Revocable Trusts. Only qualified revocable trusts may make the § 645 election. A qualified revocable trust (QRT) is a trust, or portion of a trust, that was, at the decedent's death, treated as owned by the decedent under § 676, by reason of a power in the deceased grantor to revoke the trust. IRC § 645(b)(1); Treas. Reg. § 1.645-1(b)(1). The determination of whether the grantor held the power to revoke the trust must be made without regard to § 672(e), which otherwise imputes a power held by the decedent's spouse to the decedent. Even if the decedent-grantor is incapacitated at death, the trust should qualify if an agent or legal representative of the grantor could revoke the trust during the grantor's incapacity. *See* T.D. 9032, Preamble ("Summary of Comments and

Explanation of Revisions" § A). If a joint revocable trust is involved, the decedent's right of revocation and grantor trust status would normally be limited to his or her share of the trust's property, so only the portion of the trust attributable to the deceased settlor should qualify as a QRT.

b. Procedures. Section 645(c) states that the election to treat a qualified revocable trust as part of an estate must be made not later than the date required for filing the income tax return of the estate for its first taxable year, taking into account any extensions. Once the election is made, it is irrevocable. The regulations set forth detailed requirements for the § 645 election. The regulations state that the § 645 election should be made by the decedent's executor, if there is one, and the trustee of each QRT to which the election relates. However, the election under § 645 may be made whether or not an executor is appointed for the decedent's estate. Treas. Reg. § 1.645-1(c). The trustee (and the personal representative of the decedent's estate, if there is one) makes the § 645 election by filing a form provided by the IRS (the "election form"). Treas. Reg. § 1.645-1(c)(1)(i). The trustee of the QRT makes the § 645 election by filing the election form, if there is no personal representative appointed for the decedent's estate. Treas. Reg. § 1.645-1(c)(2)(i).

(1) Trustee's Agreement. By signing the election form—and as a condition to a valid § 645 election—the trustee of each QRT joining with an executor, if any, in the election agrees: (1) to the election; (2) that the trustee is responsible for providing the executor (if any) with all trust information necessary to permit the executor to file a complete, accurate, and timely fiduciary income tax return for each taxable year during the period when the trust is treated as part of the estate (the "election period"); (3) that the trustee and the executor (if any) have agreed to allocate the tax burden of the combined trust and estate for each taxable year of the election period "in a manner that reasonably reflects the tax obligations of each electing trust and the related estate"; and (4) that the trustee is responsible for insuring that the trust's share of the trust's and estate's combined tax obligations is timely paid. Treas. Reg. § 1.645-1(c)(1)(ii)(A).

(2) Executor's Agreement. The executor agrees by signing the election form: (1) to the election; (2) that the executor is responsible for filing a complete, accurate, and timely fiduciary income tax return for each taxable year during the election period; (3) that the executor and trustee have agreed to allocate the combined tax burden in a reasonable manner; and (4) that the executor is responsible for insuring that the estate's share of the combined tax obligations is timely paid. Treas. Reg. § 1.645-1(c)(1)(ii)(B).

(3) If No Executor. If there is no executor, the trustee of each QRT joining in the election agrees: (1) to the election; (2) that, if there is more than one QRT joining in the election, the trustees of all QRTs joining in the election have appointed one trustee to be responsible for filing the income tax return for each year during the election period; (3) that, if there is more than one QRT, the trustees of all of the QRTs have agreed to allocate the trusts' tax liability for each taxable year in a reasonable manner; (4) to file a timely return for each taxable year during the election period; (5) to provide the appointed filing trustee with the trust information necessary to permit the appointed trustee to file a complete, accurate, and timely return for each taxable year; (6) to ensure that the trust's share of the tax burden is timely paid; (7) that there is no executor and, to the trustee's knowledge and belief, none will be appointed; and (8) to file a revised election form if an executor is appointed after the original election form is filed. Treas. Reg. § 1.645-1(c)(2)(ii).

(4) Due Date. If there is an executor, the election form must be filed no later than the due date for the fiduciary income tax return (including any extensions) for the first taxable year of the estate, regardless of whether there is sufficient income to require such a return otherwise. Treas. Reg. § 1.645-1(c)(1)(i). If there is no executor, the election form must be filed by the due date (including any extensions) for the QRT's income tax return, regardless of whether there is sufficient income to require such a return otherwise. Treas. Reg. § 1.645-1(c)(2)(i). If the executor of the estate is not appointed until after the trustee has made a § 645 election, the trustee and the newly appointed executor must file a new election form within 90 days of the executor's appointment. Treas. Reg. § 1.645-1(g)(1). Otherwise, the election period terminates on the day before the appointment of the executor. *Id.*

(5) Obtaining an EIN. The trustee of a QRT must obtain an employer identification number (EIN) for the trust following the decedent's death. Treas. Reg. § 1.645-1(d)(1). Under the final regulations, the trustee must obtain the EIN regardless of whether there is an executor of an estate. *Id.* If there is no executor, the trustee of a QRT furnishes the trust's EIN to the payors of the trust and uses the EIN to file fiduciary income tax returns for the trust during the entire election period. Treas. Reg. §§ 1.645-1(d)(1), -1(e)(3)(ii).

(6) Short Year Issues. If a § 645 election will be made for a QRT, the executor (if any) and the trustee may treat the trust as a QRT from the date of the decedent's death. Treas. Reg. § 1.645-1(d)(2)(i). In that case, the trustee does not need to file a fiduciary income tax return for the QRT for the short taxable year beginning with the decedent's date of death until the date of the actual election. If, on the other hand, the trustee and the executor (if any) do not treat the trust as a QRT, or if the trustee and executor (if any) are unsure whether a § 645 election will be made for a trust, the trustee must file a fiduciary income tax return for the short taxable year beginning with the decedent's death and ending on December 31 of that year. Treas. Reg. § 1.645-1(d)(2)(ii)(A). In other words, the trust must be treated as a separate entity. The trustee of a QRT must amend the trust's fiduciary income tax return if a valid § 645 election is made for the trust after a return has been filed reporting the trust as a separate entity. Treas. Reg. § 1.645-1(d)(2)(ii)(B); The trust's items of income, deduction, and credit must be excluded from the amended return and included on the return filed for the first taxable year of the combined trust and estate, if there is an executor, or for the first taxable year of the trust if there is no executor. *Id.*

c. Taxation of Electing QRT. Except to the extent required by the separate share rules of § 663(c), all items of income, deduction, and credit of the trust and the estate are combined for purposes of computing DNI and applying the distribution provisions of §§ 661 and 662. Treas. Reg. §§ 1.645-1(e)(2)(ii)(A), (iii)(A). The regulations do not provide extensive guidance for apportioning the tax liability of the combined estate and QRT between the two entities or fiduciaries. However, the fiduciaries must allocate the tax burden between the combined trust and estate "in a manner that reasonably reflects the tax obligations" of each; if the tax burden is not reasonably allocated, gifts may be deemed to have been made. *See* T.D. 9032, Preamble ("Summary of Comments and Explanation of Revisions" § B); Preamble ("Explanation of Provisions" § C).

d. Separate Share Rules. The regulations state that, for purposes of computing DNI and applying the distribution provisions of §§ 661 and 662, the trust and the estate are treated as separate shares under § 663(c). Treas. Reg. § 1.645-1(e)(2)(iii)(A). When distributions are made from one share to another share, DNI is allocated in the same manner as would have been required had the distribution been made to a beneficiary other than the other share. The share making the distribution reduces its DNI by the amount of the distribution deduction to which it would have been entitled under § 661 (determined without regard to § 661(c)), had the distribution been made to a beneficiary other than another share of the combined estate and electing QRT. Treas. Reg. § 1.645-1(e)(2)(iii)(B). Solely for purposes of calculating DNI, the share receiving the distribution increases its gross income by the same amount. Treas. Reg. § 1.645-1(e)(2)(iii)(B).

e. Time Period of the Election. The election period begins on the date of the decedent's death and terminates on the earlier of (1) the day on which both the electing trust and related estate (if any) have distributed all of their assets and (2) the day before the "applicable date." Treas. Reg. § 1.645-1(f)(1). If a federal estate tax return (Form 706) is required to be filed, the applicable date is the later of (1) the day two years after the decedent's death and (2) the day six months after the date of final determination of liability for estate tax. Treas. Reg. § 1.645-1(f)(2)(ii). If a federal estate tax return is not required to be filed, the applicable date is the day two years after the date of the decedent's death. Treas. Reg. § 1.645-1(f)(2)(i). Solely for purposes of determining the applicable date under § 645, the final determination of liability for estate tax is the earliest of the following: (1) the date six months after the issuance of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within 12 months after the issuance of the letter; (2) the date of final disposition of a claim for refund that resolves the liability for the estate tax, unless suit is instituted within six months after the final disposition; (3) the date of execution of a settlement agreement that determines the liability for estate tax; (4) the date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for estate tax, unless a notice of appeal or petition for certiorari is filed within 90 days after the issuance of the decision, judgment, decree, or other court order; and (5) the expiration of the § 6501 period of limitations for assessment of the estate tax. Treas. Reg. § 1.645-1(f)(2)(ii).

f. Termination at End of Election Period. At the close of the last day of the election period, the combined estate and QRT if there is an executor, or the QRT if there is no executor, is deemed to distribute the share (or shares) comprising the trust to a new trust in a distribution to which §§ 661 and 662 apply. Treas. Reg. § 1.645-1(h)(1). As a result, the combined estate and trust, or the trust, as the case may be, is entitled to a distribution deduction to the extent permitted under § 661 in the taxable year in which the election period terminates as a result of the deemed distribution. *Id.* The new trust must include the deemed distribution in gross income to the extent required under § 662. At the end of the election period, the new trust must obtain a new EIN. Treas. Reg. § 1.645-1(h)(3). The estate continues to report under the EIN assigned to the estate during the election period. *Id.*

g. Reporting Requirements During Election Period. Only one fiduciary income tax return is filed during the election period. If there is an executor, the executor files a single return annually, under the name and EIN of the estate, for the combined trust and estate. Treas. Reg. § 1.645-1(e)(2)(ii)(A). The name and EIN of each electing QRT must be provided on the return, as required by the instructions to Form 1041. Treas. Reg. § 1.645-1(e)(2)(ii)(A). If there is no executor, the trustee of the QRT must file a fiduciary income tax return for the QRT for each year during the election period. Treas. Reg. § 1.645-1(e)(3)(ii). The trustee uses the EIN that the trustee obtained for the trust upon the decedent's death. If there is more than one electing QRT, the fiduciary income tax return filed by the filing trustee must include the names and EINs of the other electing QRTs. *Id.*

B. State Income Taxation Of Trusts. In considering income tax consequences of trust administration, it is important to consider not only federal income tax issues, but also issues relating to state income taxes. Trusts can present unique multi-jurisdictional problems when the trust is established by a grantor in one state, administered by a trustee residing in another state, for the benefit of beneficiaries in one or more other states. Moreover, the trust may hold income-producing property situated in yet another state. Although many states have statutes designed to limit the taxation of trust income in multiple states, no state imposing an income tax wishes to lose tax revenue to another state. Therefore, these double tax prevention measures are imperfect at best. A detailed, if somewhat dated, discussion of the state tax regime attributable to trusts, together with a helpful summary of state tax rules and rates in each state, is set forth in Gutierrez and Keydel, *Study 6: State Taxation on Income of Trusts with Multi-State Contacts*, ACTEC STUDIES (2001). An updated table is found in the current ACTEC state survey (formerly ACTEC Studies), Neno, *Bases of State Income Taxation of Nongrantor Trusts*.

1. Constitutional Issues. In order to pass constitutional muster, a state seeking to impose tax on a trust's income must establish some nexus to the trust. In the words of the Supreme Court, "due process requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Miller Bros. v. Maryland*, 347 U.S. 340, 344-45 (1953). In general, states may impose a tax on nonresidents with respect to income derived within the state, so long as the tax is no more onerous than the tax imposed under like circumstances on residents of the taxing state. *Shaffer v. Carter*, 252 U.S. 37, 50 (1919).

a. The Nexus Requirement. For most states, "contacts" with the state are described in terms of "residency." A state may constitutionally tax all of the income of its residents, regardless of the source of that income. *Oklahoma Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 462-63 (1995). If a trust is determined to be a resident of a state, the state may tax the trust's undistributed income. *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937). The due process clause of the United States Constitution requires that a trust's residency be based upon a sufficient nexus between the trust and the taxing state. *Id.* at 317.

b. Contacts Supporting State Taxation. The seminal case in the area of establishing a trust's "residency" for income tax purposes points to six factors to consider in fixing this nexus. *Swift Trust v. Director of Revenue*, 727 S.W.2d 880 (Mo. 1987). These factors are (1) the domicile of the grantor; (2) the state in which the trust is created; (3) the location of the trust property; (4) the domicile of the beneficiaries; (5) the domicile of the trustee; and (6) the location of the administration of the trust. Moreover, the nexus must be tested not at the inception of the trust, but at the time that the tax is being imposed. The *Swift Trust* court held that of these six factors, the first two are irrelevant for years following the inception of the trust, and the domicile of the beneficiaries was not a sufficiently important nexus. Therefore, the other three factors (location of trust property, domicile of the trustee and location of administration) were determinative.

c. Broader Views of Contacts. Some states take a much broader view of which contacts support taxation than did the *Swift Trust* court. For example, the Connecticut Supreme Court found that the domicile of the grantor at the time of death is sufficient to establish the residence of the trust for state income tax purposes. *Chase Manhattan Bank v. Gavin*, 733 A.2d 780, 782 (Conn. 1999). The court in *Chase* distinguished the much earlier United States Supreme Court case of *Safe Deposit & Trust Co. v. Virginia*, 280 U.S. 83 (1929) on the somewhat dubious basis that the court there applied the due process clause to avoid the taxation of intangibles in multiple jurisdictions, noting that this tax issue was not now a part of the due process jurisprudence. The *Swift Trust* line of cases has also been called into question by the U.S. Supreme Court's decision in *Quill v. North Dakota*, 504 U.S. 298, 307-08 (1992), which extended the nexus test to cases in which an entity has an "economic presence" in a state, even though it does not have a physical presence there.

d. Interstate Commerce Issues. While the *Quill* decision extended the notion of nexus for due process purposes, it added new requirements for state taxation to pass muster under the Constitution's commerce clause. First, the tax must be fairly apportioned among all jurisdictions with which the entity has a nexus. Second, the trust must not discriminate against interstate commerce. Finally, the tax must be fair relative to the benefits provided to the entity by the state. 504 U.S. 298, 311. Application of these principles to the multi-state income taxation of trusts awaits further analysis by the courts.

2. State Income Tax Regimes.

a. Resident vs. Non-Resident Trusts. Most states implement their tax regimes by differentiating between "resident" and "nonresident" trusts. Therefore, a preliminary matter in determining state income tax issues is to identify the "residence" of the trust. States do not, however, apply a uniform test in determining which trust is classified as a "resident" trust. *See* Gutierrez, *Oops! The State Income Taxation of Multi-jurisdictional Trusts*, 25 U. MIAMI HECKERLING INST ON EST. PL. 12 (1991). States typically impose an income tax on all income of resident trusts, regardless of where it is earned. On the other hand, for nonresident trusts, states generally impose tax only on income derived from sources located within the taxing state. For most states, in-state revenue sources are limited to income derived from real estate located within the state, or from closely held businesses situated within the state.

b. Determining Trust Residency.

(1) Residence of the Grantor. Most states use the residency of the grantor as the starting point for fixing the residency of the trust. For example, Missouri, New York, Virginia, and the District of Columbia impose an income tax on the trust where the only contact with the state is the residency of the grantor at the time the trust is created (or in the case of a revocable trust, the time that the trust becomes irrevocable). Other states add a requirement that at least some trust property be situated in the state.

(2) Residence of the Trustee. The trustee is the legal owner of the assets of the trust. As a result, many states (e.g., Arkansas and California) use the residence of the trustee as the main criterion for fixing the trust's residence. Some states take other factors into consideration. For example, Indiana does not treat a trust as a resident trust if half or less of the trustees are resident there and the trust situs is in another state.

(3) Place of Administration. Some states, such as Colorado, Utah and West Virginia, look primarily or exclusively to the place of administration as the basis of determining a trust's residence. Other states have found that the place of administration alone is not a sufficient nexus to a state to support state income taxation. *See, e.g., Bayfield County v. Pishon*, 162 Wis. 466, 156 N.W. 463 (1916).

(4) Residency of the Beneficiary. Most states do not look to the residence of the beneficiary to determine trust residence. A beneficiary resident in the state may be taxed on income distributed to that beneficiary, but the trust is generally not taxed by virtue of the beneficiary's residence alone. *Mauire v. Tefery*, 253 U.S. 12 (1938); *Guaranty Trust Co. v. Virginia*, 305 U.S. 19 (1938). Eight states, however, do look to the residence of the beneficiary. For example, Georgia imposes a tax on trusts with beneficiaries residing in Georgia, or more precisely, a resident trustee may avoid taxation on income that is distributed to, or accumulated for later distribution to, a non-resident of Georgia, if the income is received from business done outside of Georgia or from property outside of Georgia. O.C.G.A. § 48-7-22(a)(3)(A).

(5) Income Derived from Within the State. Almost all states imposing an income tax do so on income derived from sources within the state, regardless of the residency of the trust. The benefit that the state provides to enable the production of income generally provides a sufficient nexus to permit the state to tax locally derived income of nonresident trusts. *Shaffer v. Carter*, 252 U.S. 37 (1920). Domestic income typically includes income from real or tangible property located within the state, the conduct of a business located within the state, or intangible property which has acquired a business situs within the state.

c. Selecting a Trust Situs to Avoid State Tax. State income taxation is one of several factors that a grantor may consider in selecting the situs to establish a trust. Moreover, if permitted, a trustee may seek to move the situs of a trust to a state that offers a favorable state income tax environment. For a discussion of these issues, see Warnick and Pareja, *Selecting a Trust Situs in the 21st Century*, PROB. & PROP. 53 (Mar/Apr 2002); Sligar, *Changing Trust Situs: The Legal Considerations of 'Forum Shopping'*, TR. & EST., (July 1996) at 40.

C. Estate Taxes. Several estate tax issues arise when a revocable trust becomes irrevocable upon the settlor's death. It comes as no surprise that the trust's assets are included in the settlor's gross estate for estate tax purposes.

1. Section 2038 and the Power to Revoke. Section 2038 requires that the estate of a deceased settlor include the value of a trust holding any property transferred by that settlor during his or her life, if the settlor had, at the time of death, the power to revoke the trust. The value of the trust assets is included in the deceased settlor's estate regardless of whether the power to revoke was exercisable alone or in conjunction with another person. IRC § 2038(a)(1). Therefore, if the decedent and the decedent's spouse could both revoke the trust, even if they had to act in concert, the property is includible in the decedent's gross estate under § 2038(a)(1). The value of the property held by a revocable trust is included in the deceased settlor's gross estate only if the settlor's power to revoke was exercisable on the date of death. *Id.* The settlor's gross estate does not include the value of property held by a revocable trust if the settlor's power to revoke could not be exercised until the occurrence of an event that had not actually occurred at the time of the settlor's death, or could not be exercised without the consent of another person who could not grant consent because he or she was not then living. *See* Treas. Reg. § 20.2038-1(b); *Webster Est. v. Commissioner*, 65 T.C. 968, 979 (1976). In contrast with § 2036, which applies only to retained powers, § 2038 applies to all transfers over which the transferor had at the time of death a power to alter, amend, revoke or terminate, without regard to whether the transferor retained the power at the time of the transfer or reacquired the power later. In fact, if the decedent *retained* the right to revoke a revocable trust, the trust will be includible in the settlor's gross estate under both §§ 2036 and 2038. Whether a trust is includible under § 2038 alone or under both §§ 2036 and 2038 may affect the apportionment of estate tax. For example, in TAM 199918003, the IRS stated that a revocable trust was includible in the settlor's estate under § 2036. The decedent retained the right to income from the trust and the right to amend or revoke the trust. Under § 2207B, the decedent's executor is entitled to recover from the person receiving property that was subject to a reserved income interest or power to affect beneficial enjoyment the share of estate taxes attributable to the property. The IRS National Office stated that since the revocable trust was also includible under § 2036, and not merely § 2038, the recovery right under § 2207B applied. TAM 199918003.

2. Trustee of the Revocable Trust as Executor. Various post-mortem elections may be made by the "executor" of a decedent's estate, including the use of the alternate valuation date, the deduction of certain estate expenses against income or estate taxes, the extension of time for paying certain estate taxes, and the special use valuation of farm and closely held business realty held in the estate. If the decedent died with a fully funded revocable trust, there may be no executor or administrator appointed under state law. Section 2203 provides that an "executor" for estate tax purposes is either the individual appointed to serve as executor or administrator or, if no one is appointed, "any person in actual or constructive possession of any property of the decedent." As a result, the trustee of a fully funded revocable trust will be the "executor" under § 2203 for purposes of filing the estate tax returns and making these elections, if no executor or administrator is appointed. Somewhat surprisingly, the regulations do not include the trustee of a revocable trust among their examples of an "executor." Treas. Reg. § 20.2203-1.The IRS has ruled privately, however, that the trustee of a funded revocable trust is the executor of a decedent's estate, for example, for purposes of making the QTIP election under § 2056(b)(7). PLR 8335033.

3. Alternate Valuation Date. The trustee of a revocable trust may have important responsibilities with respect to the election to value estate assets on the alternate valuation date (rather than on the date of death), even if an executor is appointed under the will and confirmed by the appropriate local authorities, because the assets in the revocable trust are generally included in the gross estate and their value will be determined by this election. Also, trust distributions of principal within six months following the date of the deceased settlor's death may establish the alternate valuation date of the distributed property. *See* § 2032(a)(1). IRS rulings on this point, however, are not altogether consistent. For example, in Revenue Ruling 57-495, the IRS concluded that a post mortem division of the principal of a revocable trust into two equal parts was not a distribution for purposes of establishing an alternate valuation date under § 2032. The trust instrument provided that, upon the settlor's death, the trust would be divided into two equal shares, with the income payable to the settlor's wife and son for life and the remainder passing to certain designated beneficiaries. The IRS explained that the division was made only to facilitate payments to the life beneficiaries; the property was not "distributed" until it became unqualifiedly subject to the demand or disposition of the remainder beneficiaries. Rev. Rul. 57-495, 1957-2 C.B. 616. In contrast, in Revenue Ruling 73-97, however, the IRS concluded that the post mortem division of the corpus of a revocable trust into separate trusts for each of the settlor's three children constituted a distribution for purposes of establishing an alternate valuation date.

The IRS attempted to distinguish Revenue Ruling 57-495 based on the fact that, in the 1957 ruling, the revocable trust did not cease to exist after the distribution, but continued uninterrupted for the lives of the income beneficiaries, and, therefore, the principal of the trust was not removed from the gross estate. In the 1973 ruling, on the other hand, the IRS viewed the distribution of the assets into multiple subsidiary trusts as removing the assets from the gross estate. Rev. Rul. 73-97, 1973-1 C.B. 404. Based upon the later ruling, one should anticipate that any distribution from a revocable trust to its beneficiaries or subsidiary trusts or to the settlor's estate may constitute a distribution for purposes of § 2032. Note, however, that in Revenue Ruling 78-431, the IRS ruled that the division of a joint revocable trust into two separate trusts upon the death of one spouse, and the distribution of the surviving spouse's trust interest to a new trust within six months after the deceased spouse's death, did not constitute a distribution of the deceased spouse's interest for alternate valuation date purposes. Rev. Rul. 78-431, 1978-2 C.B. 230.

4. Deduction of Estate Administration Expenses. The executor may generally elect to deduct estate administration expenses on the estate tax return, or on the estate's income tax return as a deduction in computing taxable income. Section 642(g) provides that the executor may not elect to deduct these expenses on both returns. Administration expenses incurred by the trustee of the revocable trust may be deducted on the estate tax return or on the trust's own income tax return. They are deductible on the estate tax return if the trust assets are subject to the claims and debts of the estate, which depends largely on state law and the terms of the trust instrument. Treas. Reg. § 20.2053-1(a)(1). If the assets of a revocable trust are not available to satisfy the debts and expenses of the estate, the trust's expenses are deductible on the estate tax return only if they are incurred by reason of the decedent's death and are incurred in vesting good title in the beneficiaries of the trust. Treas. Reg. § 20.2053-8(b). Furthermore, deductible estate administration expenses incurred by the trust in excess of the assets subject to claims may only be deducted on the estate tax return if they are paid before the return is filed. Treas. Reg. § 20.2053-1(c)(2).

5. Discharge of the Trustee's Liability. Generally, the Code provides that the person in possession of property includible in the gross estate is liable for taxes. As a result, the executor and the trustee of a funded revocable trust are each liable for the estate taxes applicable to the property under their control. IRC § 6324(a)(2). Originally, only the executor could request a discharge from personal liability for the tax under § 2204, but this benefit was extended to trustees of revocable trusts established by decedents dying after December 31, 1970. IRC § 2204(b). *Cf.* Rev. Rul. 57-424, 1957-2 C.B. 623 (holding that only the executor of the estate, and not the trustee of an inter vivos trust could apply for discharge from personal liability under IRC § 2204(b)).

6. Spouse-Owned Life Insurance. Normally, when a revocable trust is to be funded with life insurance, the insured should either retain ownership of the insurance policy or assign it to the trustee. The insured should not assign the ownership of the policy to his or her spouse or another person if the revocable trust is the policy beneficiary. The consequences of doing so are illustrated by the issues raised in *Margrave's Est. v. Commissioner*, 618 F.2d 34 (8th Cir. 1980), *aff'g* 71 T.C. 13 (1978). There, the insured's wife bought a life insurance policy on her husband's life, designating his revocable trust as beneficiary. The beneficiary designation was revocable by her at any time. The IRS contended that the husband had the ability to change the beneficiary of the life insurance policy by modifying his trust and that this ability constituted an incident of ownership in the policy under § 2042(2). The Tax Court (with eight judges dissenting) and the Eighth Circuit both rejected the IRS's position, finding that the husband's interest in the policy was too insubstantial to constitute an incident of ownership. Rather, they characterized his interest as "a mere power over an expectancy." 618 F.2d at 37. In response to *Margrave's Est.*, the IRS issued Revenue Ruling 81-166, involving a virtually identical fact pattern. The IRS stated that it would not challenge the position of the Tax Court and Eighth Circuit in *Margrave's Est.*, but that, on the insured's death, the spouse would be deemed to have made a completed gift for gift tax purposes of the actuarial value of the remainder interest in the proceeds to the remainder beneficiaries of the trust. The IRS reasoned that the initial designation of the trust as the beneficiary should be treated as an incomplete transfer, completed on the insured's death. Consequently, the surviving spouse incurred a potentially significant gift tax liability when the insured died. The IRS also noted that, because the insured's death completed the surviving spouse's gift to the trust and the spouse had the income interest in the trust, at the surviving spouse's death, all of the proceeds held in the trust would be includible in the surviving spouse's gross estate under § 2036(a), as a gift with a retained life interest. Rev. Rul. 81-166, 1981-1 C.B. 477.

7. Joint Property Held in a Revocable Trust. The entire value of property owned jointly with a right of survivorship by a decedent and someone other than his or her spouse (or the spouse, if the spouse is not a U.S. citizen) is includible in the decedent's gross estate under § 2040(a), except to the extent that it can be shown that the surviving joint owner contributed part of the purchase price. IRC § 2040. Only one-half (or such other percentage as may be applicable by agreement or because there are more than two joint owners) of the value of property owned as tenants in common (without a right of survivorship) is included in the estate of the first joint owner to die. Treas. Reg. § 20.2040-1(b). In *Black v. Commissioner*, 765 F.2d 862 (9th Cir. 1985), a husband and wife transferred to their joint revocable trust property that had been owned by them jointly with rights of survivorship. When the husband died, the IRS sought to include one half of all of the former joint tenancy property in the taxable estate of the husband under § 2040. Although the Tax Court agreed with the IRS, the Ninth Circuit ruled that a conversion from joint ownership occurred when the co-owners transferred the assets to the revocable trust, yielding different rights over the revocable trust from those they held over the joint property. As a result, only the assets belonging to the husband prior to being contributed to the trust were includable in his estate for federal estate tax purposes.

D. <u>Special Use Valuation.</u> An estate may value real estate used in a farm or closely held business at its value for the use for which it qualifies under § 2032A, rather than at its highest and best use if certain requirements are met. One of these requirements is that the deceased or his or her family must have "materially participated" in the operation of the farm or business. IRC § 2032A(b)(1)(C)(ii). In *Sherrod Est. v. Commissioner*, 774 F.2d 1057 (11th Cir. 1985), the issue was whether one can materially participate in the operation of a farm held in a revocable trust. There, the deceased's executors elected to value three separate tracts of farmland under § 2032A. The decedent had transferred the tracts to a revocable trust, naming his son and daughter as trustees. The son, as trustee, entered into rental agreements for the crop and pasture, and put the timberland in a passive management arrangement. The Tax Court held that the son still exercised control over the property and engaged in an active business. The Eleventh Circuit reversed the Tax Court on other grounds, but held that the Tax Court did not err in concluding that the son materially participated in the operation of the farm, and that as a result, that requirement for special use valuation was satisfied.

VIII. <u>CONCLUSION</u>

Revocable trusts are an increasingly popular tool for estate planning. For many practitioners, especially those in states where court supervision of estates and testamentary trusts remains the norm, revocable trusts are the standard dispositive tool. In recognition of the fact that revocable trusts are frequently used as will substitutes, courts, state legislatures and Congress have all acted to narrow the differences between administration of post-death revocable trusts and estates. In many cases, these steps have made the decision to use revocable trusts more neutral, both from the standpoint of administration and taxes. Many differences remain, however. It is incumbent upon estate planning practitioners, both those that use revocable trusts as their "default" tool and those who encounter revocable trusts prepared by others, to understand the remaining distinction involved in administering revocable trusts.