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Editor: Robert P. Achenbach, Jr. esq.

Contributing Editor Dr. Neil E. Harl, esq.

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## FUNDING REVOCABLE LIVING TRUSTS

— by Neil E. Harl\*

Without much doubt, the transfer of assets to the trust is the most critical part of the formation of a revocable living trust.<sup>1</sup> Inasmuch as all of the grantor's property should be conveyed to the trust, the obvious question is whether the transfer triggers adverse consequences to the grantor. In general, conveyance of property to a revocable inter vivos trust can be accomplished without negative consequences but the property inventory should be subjected to an item-by-item review before the actual transfer occurs. Here are the major points to consider.

**Transfer of residence.** The transfer of the principal residence impacts several different options open to most grantors.

- The transfer of the principal residence to a revocable living trust does not make the residence ineligible for a tax-free rollover into a replacement residence within the statutory two-year period.<sup>2</sup>

- Likewise, the transfer does not preclude eligibility for the exclusion (for grantors age 55 or older) up to \$125,000 of gain on the principal residence.<sup>3</sup> Indeed, if the principal residence is transferred to an *irrevocable* living trust, the residence is eligible for the \$125,000 exclusion to the extent the grantor is treated as the owner of the trust.<sup>4</sup>

**Depreciation.** Depreciation or cost recovery deductions are apportioned between the trustee and the income beneficiaries as the trust income is allocated.<sup>5</sup> However, *expense method depreciation does not apply to trusts.*<sup>6</sup>

**Installment payment of estate tax.** Property interests are not made ineligible for installment payment of federal estate tax if held in a revocable living trust at death.<sup>7</sup> Conveyance of property already subject to an election to pay the federal estate tax in installments could terminate installment payment during the 177-month period after death unless the transfer is a mere change in organizational form.<sup>8</sup>

**Special use valuation.** Land held in a revocable living trust at death remains eligible for special use

valuation for federal estate tax purposes<sup>9</sup> if the requirements are otherwise met.<sup>10</sup> Recapture of special use valuation benefits could occur on transfer unless all trust beneficiaries are family members of the transferor and consent to personal liability for the recapture tax.<sup>11</sup>

**Government savings bonds.** Series E or EE government savings bonds may be transferred without causing recognition of gain as to accrued interest.<sup>12</sup> The election to report the accrued interest in the final income tax return of the decedent is still available.<sup>13</sup>

For bonds held by one spouse payable on death to the other spouse, transfer to a trust owned by both and reissuance in the name of the trustee is likewise not a taxable event.

**Installment sale obligations.** Installment sale contracts may be transferred without accelerating recognition of gain.<sup>14</sup> However, gain may be recognized if the obligor on the installment contract is also a beneficiary of the trust.<sup>15</sup>

**Corporation stock.** Transfer of corporate stock to a revocable living trust may produce adverse tax consequences.

- The ordinary loss deduction available for "Section 1244" stock does not apply if the stock is disposed of by a trust, regardless of how acquired.<sup>16</sup>

- Under the law of many states, stock in professional practice corporations must be owned by individuals licensed to practice the profession.<sup>17</sup>

- A grantor trust can own S corporation stock up to the grantor's death and for 60 days thereafter; the trust can own stock for two years after death if the entire trust corpus is included in the grantor's estate.<sup>18</sup> "Subchapter S" trusts with a single income beneficiary and trusts with another than the grantor deemed to be the owner may also own S corporation stock.<sup>19</sup>

**Joint tenancy property.** Conveyance of joint tenancy property to a revocable living trust apparently results in severance of the joint tenancy characteristic<sup>20</sup> although the Tax Court has held otherwise.<sup>21</sup>

\* Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

## FOOTNOTES

- <sup>1</sup> See generally 8 Harl, Agricultural Law § 62.04[3]. (1992).
- <sup>2</sup> Rev. Rul. 66-159, 1966-1 C.B. 162. See I.R.C. § 1034.
- <sup>3</sup> Ltr. Rul. 8007050, Nov. 23, 1979.
- <sup>4</sup> Ltr. Rul. 8239055, June 29, 1982 (trustee was adverse party as to 25 percent of trust so 75 percent of residence eligible); Ltr. Rul. 9118017, Feb. 1, 1991 (trustors had power unlimited by any conditions, to remove trustee and substitute anyone, including themselves as trustee; trustee had power to make discretionary distributions from income and principal and not limited by reasonably definite standard).
- <sup>5</sup> Treas. Reg. §§ 1.611-1(c)(4), 1.167(h)-1(b).
- <sup>6</sup> I.R.C. § 179(d)(4).
- <sup>7</sup> Ltr. Rul. 7747007, Aug. 19, 1977; Ltr. Rul. 8132027, May 1, 1981.
- <sup>8</sup> See Ltr. Rul. 8326023, March 23, 1983 (no acceleration on transfer of corporate stock to grantor trust, when grantor trust terminated with corpus distributed to beneficiaries or when trust terminated by reason of death of beneficiary with interest passing to family member). See also Ltr. Rul. 9116009, Jan. 15, 1991 (transfer of property from one revocable living trust to another inter vivos trust (of heir) were change in form and not disposition).
- <sup>9</sup> See I.R.C. § 2032A.
- <sup>10</sup> See I.R.C. § 2032A(g). See 5 Harl, Agricultural Law § 43.03[2][e] (1992).
- <sup>11</sup> I.R.C. § 2032A(c).
- <sup>12</sup> Ltr. Rul. 7826024, March 28, 1978; Ltr. Rul. 9009053, Dec. 6, 1989 (grantor considered to be owner of revocable living trust).
- <sup>13</sup> Ltr. Rul. 7907120, Nov. 17, 1978.
- <sup>14</sup> Rev. Rul. 74-613, 1974-2 C.B. 153.
- <sup>15</sup> See I.R.C. § 691(a).
- <sup>16</sup> I.R.C. § 1244(d)(4).
- <sup>17</sup> E.g., Iowa Code § 496C.10.
- <sup>18</sup> I.R.C. § 1361(c)(2).
- <sup>19</sup> *I.d.*
- <sup>20</sup> *Black v. Comm'r*, 765 F.2d 862 (9th Cir. 1985).
- <sup>21</sup> *Est. of May v. Comm'r*, T.C. Memo. 1978-20.

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## CASES, REGULATIONS AND STATUTES

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by Robert P. Achenbach, Jr.

### ADVERSE POSSESSION

**CONTINUOUS POSSESSION.** The disputed land was created by rimrock which prevented placing a fence on the true boundary between the parties' properties. The disputed area was unimproved and not used by the defendant until 1989 when the defendant rebuilt the fence as part of a pasture. The plaintiff sought an injunction and the defendant asserted ownership of the disputed land by adverse possession. The court upheld judgment for the plaintiff because the defendant failed to show actual, open, visible and continuous occupancy for more than 20 years. The defendant argued that the doctrine of boundary by acquiescence applied because the fence had been recognized as the boundary for over 20 years. The court disagreed and held that the doctrine of boundary by acquiescence applied only as to the element of hostile occupancy and first required actual and continuous occupancy in order to be applied. **Lien v. Beard**, 478 N.W.2d 578 (S.D. 1991).

### BANKRUPTCY

#### GENERAL

**ABSOLUTE PRIORITY RULE.** The debtors owned a farm under a sole proprietorship and in their Chapter 11 plan proposed to contribute their labor and exempt property to the farm business to satisfy the absolute priority rule. The debtors' attorney also agreed to be paid out of future farm earnings instead of estate property. The debtors claimed that because the farm business had little or no "going concern" value, the debtors did not retain any interest of value. The court rejected this argument, noting that the U.S. Supreme Court in *In re Ahlers*, 485 U.S. 197 (1988), held that the retained control over the business and possible future earnings from the business were not sufficient retained interests to invoke the absolute priority rule. The court held that there was no new value exception to the absolute priority rule, but even under such an

exception, the debtors' contribution must be necessary for the reorganization and must be substantial and exceed the value of the debtors' retained interests in the business. The debtors were held not to have met the burden of showing their entitlement to the exception. ***In re Drimmel*, 135 B.R. 410 (D. Kan. 1991), aff'g, 108 B.R. 284 (Bankr. D. Kan. 1989).**

**AUTOMATIC STAY.** The debtor was a 50 percent shareholder in a corporation with one other 50 percent shareholder. Because of disagreements between the shareholders, a provisional director was appointed prior to the debtor's filing for bankruptcy. After the debtor filed for bankruptcy, the other director persuaded the provisional director to vote in favor of issuing additional stock to the other director in exchange for corporate debt held by the director, thus decreasing the debtor's stock share to less than 50 percent. The debtor sought to avoid the stock transfer as violating the automatic stay and the other director sought relief from the automatic stay for a state court action to remove the provisional director. The court held that the actions of the corporation through its board of directors did not violate the automatic stay in a shareholder's bankruptcy case but that a state court action in which the debtor was named as a defendant was stayed by the bankruptcy case. ***In re Calvert*, 135 B.R. 398 (Bankr. S.D. Cal. 1991).**

**AVOIDABLE LIENS.** The debtor claimed an exemption in household goods subject to a nonpossessory, nonpurchase money security interest. Under Ohio Code § 2329.66, an exemption in such property was allowed only where the property was not subject to a third party lien. The court held that under *Owen v. Owen*, 111 S.Ct. 1833 (1991), the test for avoidable liens against exempt property was whether the property was exempt but for the lien. Therefore, the Ohio limitation on the exemption did not prevent avoidance of the lien. ***In re Sullens*, 135 B.R. 288 (Bankr. S.D. Ohio 1991).**