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Consequences of Conveying Joint Tenancy Property or Tenancy by the Entirety Property to an Irrevocable Inter Vivos Trust

-by Neil E. Harl*

It's been a perplexing problem for years but it seems to be increasing as more of the situations come to light – years ago, grandparents conveyed property owned in joint tenancy (or tenancy by the entirety) to an irrevocable inter vivos trust with retained life estates for each of the grandparents and with a remainder interest to the children. As a variation, the grandparents in setting up the trust gave life estates to the children with a remainder interest to grandchildren. The grandparents are now deceased and the questions are two fold – (1) what is included in the gross estates of each of the grandparents and (2) what is the basis in the hands of the children (or grandchildren)?[1] The problem is drawing attention, partly because of the rapid escalation of farmland values (many of the trust situations involve farmland or vacation property) and partly because income tax considerations are now viewed as more significant than federal estate tax problems with the $5 million applicable credit amount available, at least for 2011 and 2012.[2]

Death of the first grandparent to die

For property owned in joint tenancy (or tenancy by the entirety) prior to the conveyance to the irrevocable inter vivos trust, which provided income to the grandparents for their joint lives, with the corpus going to children (or grandchildren), the first question is how much of the value is included in the gross estate in the estate of the first to die and how much receives a new basis at that death? The statutory rule, of course, is that it all depends upon whether – (1) the "fractional share" rule[3] applies, in which case 50 percent of the value would be included in the estate of the first to die; (2) the "consideration furnished" rule applies[4] in which case up to 100 percent of the value is included in the estate of the first to die, depending upon who provided the consideration on acquisition and when any indebtedness is paid off; or (3) the so-called *Gallenstein*[5] rule prevails in which case the "consideration furnished" rule applies for real estate acquired after 1954 and before 1977 even in a husband-wife situation. The answer is that none of the three govern the situation inasmuch as the three are all based on I.R.C. Sec. 2040 and the courts have held that those rules *only apply if the property is retained until death in joint tenancy or tenancy by the entirety*. That is not the case where the jointly-owned property was conveyed to a trust during their joint lives. Thus far, the cases (and a revenue ruling) have held that one-half would be included in the estate of the first to die and one-half would receive a new income tax basis. In all of the cases, state law made it clear that when joint tenancy (or tenancy

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by the entirety) property is conveyed to a trust, only one-half is considered owned by the decedent and thus one-half would be included in the gross estate and would receive a new basis, not all of the property value.[6] Indeed, the Internal Revenue Service had argued in the cases that 100 percent of the value should be included in the gross estate under the "consideration furnished" rule[7] which was then in effect for husbands and wives (the first of the spouses to die had provided all of the consideration). That argument was rejected, first by the Seventh Circuit Court of Appeals, in *Glaser, Jr. v. United States*[8] and then by the Tenth Circuit Court of Appeals in *United States v. Heasty.*[9] In *Rev. Rul. 69-577,*[10] the Internal Revenue Service revoked a 1957 ruling[11] and adopted the same position as the two circuit courts of appeal with one-half of the value of joint tenancy (or tenancy by the entirety) property included in the gross estate of the first to die.[12] Thus, 50 percent would receive a new basis at death, where the transfer was to a trust with a retained life estate for the husband and wife. Thus, under the revised IRS position, one-half would be included in the estate of the first to die and would receive a new basis *as to that one-half interest*.

Death of the surviving grandparent

At the later death of the surviving grandparent, the question is whether one-half or 100 percent of the value at the time of the survivor's death would be included in the survivor's estate and would receive a new basis. Although there is less direct authority, it would appear that the survivor's one-half interest (the one-half interest the survivor had dating from the earlier conveyance to the trust) would be taxed in that estate.[13] The fact that the survivor had a *granted* life estate in the pre-deceased spouse's one-half interest does not cause inclusion in the survivor's estate and would not be eligible for a new basis at death. The survivor had never "owned" the other one-half interest.

Effects of depreciation

Depreciation of depreciable improvements as well as any additional depreciable improvements added between the two deaths would require an adjustment to the basis figures.

The resulting basis

The income tax basis thus would be one-half derived from the values at the first death and one-half would be derived from the values at the survivor's death. Those values would provide the initial basis for the "uniform basis" allocations to the life estates and remainder interests from the respective estates.[14] All of this assumes, of course, that state law on conveyance of joint tenancy or tenancy by the entirety property to an irrevocable trust granting a life estate to the survivor would treat each of the decedents as owning one-half of the interest involved. Moreover, it assumes that the conveyance to the irrevocable trust would sever the joint tenancy.

Severance of joint ownership

That issue, of whether the conveyance of joint tenancy or tenancy by the entirety property to an irrevocable inter vivos trust effects a severance of the joint ownership feature, was discussed in several of the authorities cited above.[15] The cases on severance on conveyance of jointly-owned property to a trust are not in complete agreement on that point with the Tax Court holding that there was no severance where joint tenancy property was transferred to a trust and was subject to a joint power of revocation.[16] The Ninth Circuit Court of Appeals, on the other hand, held that the terms of the trust substantially diminished the survivor's right of survivorship.[17] The cases of *Glaser, Jr. v. United States*[18] and *United States v. Heasty*[19] did not discuss that aspect of the matter inasmuch as trusts were not involved but found that conveyances of remainder interests to children or grandchildren with retained life estates resulted in only one-half included in the estates of the first to die. While an argument could be made that if the joint ownership is not severed, at the first death the right of survivorship prevails and the entire value would be included in the estate of the survivor just as would have occurred had the property remained in joint ownership and not been transferred to the trust. That would mean full inclusion of the total value in the estate of the survivor and a new basis at the survivor's death for the entire value. However, the weight of authority would seem to be decidedly against that argument.

ENDNOTES

[1] See Harl, "Income Tax Basis for a Remainder Interest," 21 *Agric. L. Dig.* 25 (2010); Harl, "Hazards of Basing an Estate Plan on Successive Life Estates," 20 *Agric. L. Dig.* 137 (2009). See generally, 8 Harl, *Agricultural Law*, § 62.02, 43.02[6] (2011); Harl, *Agricultural Law Manual*, § 5.02[4] (2010); 1 Harl, *Farm Income Tax Manual*, § 3.20[4][l][i][F] (2011 ed.).

[2] The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 302(a)(1), 302(a)(2), amending I.R.C. §§ 2010, 2001(b)(2)(B).

[3] I.R.C. § 2040(b).

[4] I.R.C. § 2040(a).

[5] Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992) (entire value included in husband's estate and entire value received a new income tax basis).

[6] E.g., Miller v. United States, 325 F. Supp. 1287 (E.D. Pa. 1971) (court held that transfer of joint tenancy property to children with retained life estate destroyed its joint character).

[7] I.R.C. § 2040(a).

[8] 306 F.2d 57 (7th Cir. 1962) (transfer of real estate owned as tenancy by the entirety to children, reserving a life estate to themselves; conveyance to children destroyed tenancy by the entirety and half included in gross estate).

[9] 370 F.2d 525 (10th Cir. 1966) (decedent and wife conveyed jointly-owned property to children and grandchildren with reserved life estates; half included in gross estate.

[10] 1969-2 C.B. 173.

[11] Rev. Rul. 57-448, 1957-2 C.B. 618.

[12] See Ltr. Rul. 8331005, April 22, 1983 (tenancy by the entirety property transferred to inter vivos trust, retaining a joint and survivor life estate, remainder to children; half included in gross estate of first to die).

[13] See TAM 8303006, Aug. 12, 1982 (at death of the survivor after tenancy by the entirety property had been conveyed to children with retained life estates, but not in trust, tenancy by the entirety character was destroyed and half was taxable in the survivor's estate).

[14] See Harl, "Income Tax Basis for a Remainder Interest," 21 *Agric. L. Dig*. 25 (2010).

[15] Miller v. United States, 325 Fed. Supp. 1287 (E.D. Pa. 1971); Rev. Rul. 69-577, 1969-2 C.B. 173; Ltr. Rul. 8331005, April 22, 1983.

[16] Estate of May v. Comm'r, T.C. Memo. 1978-20.

[17] Black v. Comm'r, 765 F.2d 862 (9th Cir. 1985).

[18] 306 F.2d 57 (7th Cir. 1962).

[19] 370 F.2d 525 (10th Cir. 1966).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

PREFERENTIAL TRANSFERS. The debtor operated a corn and soybean seed company which contracted with seed growers on an annual basis. For many years the payment for the prior year's seed crop from each grower was made on May 1 or within ten days after pricing of the seed when the pricing occurred after May 1. Seed pricing occurred after the seeds were tested to determine whether the seeds met the minimum standards set by the debtor. In the year before filing for bankruptcy, the debtor changed the payment time to June 10, which fell within 90 days before the bankruptcy petition. The bankruptcy trustee petitioned to recover the payments as preferential under Section 547(b). The debtor argued that the payments were not made for an antecedent debt, Section 547(b)(2), because payments were not required until the seeds were bagged and sold. The court held that the debtor became obligated for payment when the seeds were tested, which occurred prior to payment; therefore, the payments were made for an antecedent debt. The debtor also argued that the payments were a contemporaneous exchange for new value under Section 547(c)(1). The court held that no new value was acquired by the payments since the seeds were grown and delivered prior to payment. Finally, the debtor argued that the payments were made in the ordinary course of business under Section 547(c)(2). The court noted that this argument would have succeeded if the payment timing had not changed in the year before the bankruptcy filing; however, the ordinary course of business created between the debtor and the seed growers had been to pay by May 1. Since the payment timing was changed, the payments were no longer made in the ordinary course of business, as defined by the parties. The debtor appealed the last issue as to whether the payments were made in the ordinary course of business. The appellate court affirmed on this issue. ***In re* Patriot Seeds, Inc., 2011 U.S. Dist. LEXIS 35240 (C.D. Ill. 2011), *aff'g*, 2010 Bankr. LEXIS 294 (Bankr. C.D. Ill. 2010)**.

FEDERAL TAX

DISCHARGE. The debtors, husband and wife, filed for Chapter 7 in November 2008 and filed their income tax returns for 1995 through 2006 in December 2008. The IRS did not file a claim in their case and the case was closed in June 2009 with a discharge granted. The debtors sought a ruling that the 1995 through 2006 taxes were discharged. The court held that, because the tax returns were not filed pre-petition, the taxes were nondischargeable under Section 523(a)(1)(B)(ii). **Pansier v. United States, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,360 (E.D. Wis. 2011), *aff'g*, 2010-2 U.S. Tax Cas. (CCH) ¶ 50,759 (Bankr. E.D. Wis. 2010)**.

FEDERAL FARM PROGRAMS

ORGANIC. The AMS has issued a proposed rule which clarifies a provision of the Organic Foods Production Act of 1990 and the regulations issued thereunder that require periodic residue testing of organically produced agricultural products by accredited certifying agents. The proposed rule would amend the USDA National Organic Program regulations to make clear that accredited certifying agents must conduct periodic residue testing of agricultural products that are to be sold, labeled, or represented as "100 percent organic," "organic," or "made with organic (specified ingredients or food group(s))." The proposed rule would expand the amount of residue testing of organically produced agricultural products by clarifying that sampling and testing are required on a regular basis. The proposed rule would require that certifying agents, on an annual basis, sample and conduct residue testing from a minimum of five percent of the operations that they certify. **76 Fed. Reg. 23914 (April 29, 2011)**.