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A HOUSE DIVIDED: THE PURCHASE BY THE SURVIVING SPOUSE OF AN INTEREST IN THE FAMILY RESIDENCE FOLLOWING ITS ALLOCATION TO A CREDIT TRUST

*By James P. Lamping, Esq.**

I. INTRODUCTION

Following the death of the first spouse, the allocation of the family residence in a two trust division can present unique challenges for the trustee.[1] Commonly, the value of the residence exceeds one half of the value of the community trust estate to be divided. However, it is generally disadvantageous to the surviving spouse for even a fractional share of the residence to be held by a credit trust.

One solution to this dilemma is for the surviving spouse to buy back the share that has been allocated to the credit trust. While this technique can be effective and is frequently used in practice, certain issues should be considered before completing this transaction. In particular, the trustee of the credit trust may be confronted with tensions between their fiduciary duties to the remainder beneficiaries and the desire to permit the surviving spouse to purchase the residence. There is also some concern regarding the income tax consequences of this transaction. This article will examine this common scenario, and analyze the practical considerations the trustee may wish to take into account before taking action.

II. THE DILEMMA

The family residence often is the largest single asset to be divided following the death of the first spouse in a two or three trust division, particularly in modest estates. A common result is that a portion of the family residence must be funded into the credit trust.

For example, suppose that a joint trust holds two items of community property: a residence worth $1 million and a brokerage account with a value of $500,000.[2] One half of the $1.5 million total value of these assets, or $750,000, must be allocated to the credit trust.[3] Even if the entire $500,000 brokerage account is allocated to the credit trust using a non-pro rata allocation, the trustee still must allocate $250,000 from the residence to the credit trust.[4]

A surviving spouse may react negatively to an allocation of any interest in his or her residence to the credit trust for several reasons. The first reaction may be purely visceral: a person's home is usually very personal to them, and often symbolizes stability and security, particularly after the death of a spouse. Now confronted with the thought of even a portion of their residence being allocated to a credit trust, the surviving spouse may ask "what do you mean I won't own my home any more?"

This transaction may also be disadvantageous from a purely rational business perspective. Credit trusts were traditionally used to minimize estate tax at the second spouse's death. While this often results in negative income tax results, the estate tax rate was high enough that a family could achieve overall tax savings. However, with the increase in the applicable exclusion amount, estate taxes are no longer a concern for many middle class clients. This leaves only the potentially negative income tax results, with no corresponding estate tax benefit. Nevertheless, credit trusts often continue to play a vital role in estate planning for middle class clients. For example, a credit trust may be used to provide for the surviving spouse while ensuring that assets will pass to the deceased spouse's children, or to protect the surviving spouse from elder abuse or undue influence.[5]

Unlike estate tax consequences, which may arise upon the death of the surviving spouse, the income tax impact of the family residence being held by the credit trust may occur during the surviving spouse's lifetime. For example, Internal Revenue Code (hereafter, "IRC") section 121 generally permits a taxpayer to exclude from income $250,000 of gain on the sale of a residence "owned and used by the taxpayer as the taxpayer's principal residence" for two of the last five years. However, that portion of the residence allocated to the credit trust is not "owned by the taxpayer."[6] As a result, it may be necessary for capital gains taxes to be paid upon the future sale of the residence, where they could have been avoided if the residence had been owned outright by the surviving spouse.

The surviving spouse may also lose the home mortgage interest deduction with respect to the portion of the residence held by the credit trust. Theoretically, the home mortgage interest deduction may be taken by the credit trust if the surviving spouse uses the property as a residence.[7] The practical problem is that the credit trust may have little or no income if its primary asset is the surviving spouse's home, meaning that the deduction may be lost entirely, as the trust will have no income to offset.[8]

Assuming that the surviving spouse will not disinherit the remainder beneficiaries, the retention of the residence by the credit trust may be even less attractive. Where it is anticipated that there not will be an estate tax payable at the death of the second spouse, the remainder beneficiaries will not receive a stepped-up basis as to that portion of the residence allocated to the credit trust.[9] Because no estate taxes would have been imposed in any event, no estate tax savings have been achieved. Even where it is anticipated that there may be an estate tax upon the death of the surviving spouse, the allocation of the residence to the credit trust may preclude certain estate planning techniques by the surviving spouse.[10] For these reasons, the surviving spouse often desires to own the residence outright.

III. A POSSIBLE SOLUTIO3N

Many of the difficulties associated with the credit trust owning an interest in the surviving spouse's residence may be avoided by having the surviving spouse purchase the share allocated to the credit trust.

For example, suppose that a two settlor trust consists entirely of a community property residence with a value of $2 million, and that one half of the residence is allocated to the credit trust immediately after the death of the first spouse.[11] The surviving spouse immediately buys the half interest allocated to the credit trust for $1 million, using a note secured by a deed of trust. Following this transaction, the surviving spouse owns the $2 million residence subject to a debt of $1 million (in other words, $1 million in equity), and the credit trust owns the $1 million note secured by the residence.

This example sounds simple, but there may be a number of practical complicating factors. In particular, careful consideration should be given to the trustee's fiduciary duties, particularly if the surviving spouse is acting as trustee of the credit trust. Moreover, the holding of the secured note may create income tax consequences for the surviving spouse and the credit trust. In practice, many practitioners just disregard the theoretical income tax accounting implications of this transaction; however, there is some risk in choosing this path.

IV. FIDUCIARY DUTIES

As described above, a purchase of the residence from the credit trust may be very attractive from the surviving spouse's perspective. The remainder beneficiaries, however, may be less enthusiastic. Once the transaction is completed, the surviving spouse will own the residence outright. This means that all future appreciation associated with the residence will inure solely to the surviving spouse. Meanwhile, the credit trust will hold a note that will not increase in value.

For example, suppose that a community property residence with a total value of $2 million is the sole asset in a two trust division. One half of the residence is allocated to the survivor's trust, and the other half is allocated to the credit trust. The surviving spouse purchases one half of the residence from the credit trust in exchange for a $1 million note. The surviving spouse now owns the entire residence, subject to the debt. The surviving spouse remarries several years later, and amends the survivor's trust to leave everything to the new spouse, rather than the children of the deceased spouse.[12] Upon the death of the surviving spouse many years later, the value of the residence has increased to $3,000,000. The surviving spouse's new spouse receives the $3,000,000 residence less the $1 million owed to the credit trust, or $2,000,000. In contrast, the stepchildren receive $1,000,000 that was repaid from the surviving spouse's estate to the credit trust. The stepchildren may not embrace this result.

The duties imposed upon trustees by the Probate Code may provide a number of bases for attacking this transaction. In particular, the stepchildren may complain that the stepparent-trustee has breached the duty of loyalty,[13] the duty to deal impartially with beneficiaries,[14] the duty to avoid conflict of interest,[15] the duty to make trust property productive,[16] and perhaps other duties as well.[17] Even where the boilerplate language of a trust provides that a trustee has broad discretion, the Probate Code imposes a duty to exercise discretionary powers reasonably.[18] Moreover, a general statement in a trust that the trustee is not bound by the Uniform Prudent Investor Act will not necessarily save the trustee from liability under the Act, even where the trust holds publicly traded stock.[19] Holding a single note, even one secured by real property, could be even riskier.

That is not to say that a trust could not provide the trustee with the ability to complete this transaction. A settlor may authorize a trustee to favor one class of beneficiaries over another, and indeed may make a challenge of the trustee's decision to do so a violation of the trust's no contest clause.[20] Providing the spouse with the option to engage in this transaction does not inherently violate public policy. However, careful drafting is necessary at the planning stage.

A separate section below proposes draft language that may be adopted to permit the surviving spouse to engage in this transaction, but one issue in particular should be considered in the context of the surviving spouse's fiduciary duties as trustee.

One method of ameliorating the loss of appreciation inuring to the benefit of the remainder beneficiaries is to provide that interest shall accrue during the lifetime of the surviving spouse, but will not actually be paid to the credit trust until his or her death. If such a provision is used, careful thought should be given to the interest rate that will be used for the note. For example, the prime rate in 1980 reached 20 percent. If interest were to accrue at this rate, all of the equity purchased from the credit trust may be used to pay the accrued interest upon the surviving spouse's death.[21]

V. INCOME TAX ISSUES

A. Will the Secured Note Create Income Tax Consequences?

Practitioners commonly ignore the buyback transaction entirely for income tax purposes. This is somewhat supported by the argument that since the surviving spouse is the person entitled to receive the income of the credit trust, the payment of interest (or imputed interest) by the surviving spouse should be ignored. In other words, the trustee may ignore this arrangement because the surviving spouse is on both sides of the transaction. A closer examination reveals some risks to this approach.

One potential issue is that the assets of the credit trust may be included in the estate of the surviving spouse for estate tax purposes if the credit trust is not treated as a separate entity during the surviving spouse's lifetime.[22] The precise impact of this circumstance may vary widely from case to case, and will not present an estate tax issue until the death of the surviving spouse.[23] However, an

audit of the credit trust may result in the immediate imposition of income tax liability.

The grantor trust provisions of the Internal Revenue Code typically will not apply to a credit trust.[24] Consequently, a credit trust is a taxable entity separate and apart from the surviving spouse for income tax purposes.[25] Where a credit trust holds investments that generate income from a third party, that is not a problem. For example, interest paid to a typical credit trust by a third party would in many circumstances be taxable to the surviving spouse.[26] The income tax result is essentially the same as if the surviving spouse held the note directly. It is unlikely that the surviving spouse will complain about receiving the income tax bill associated with the interest where they are also receiving the income.

When the surviving spouse borrows from the credit trust, the surviving spouse will owe interest to the credit trust.[27] Inasmuch as the credit trust is a separate entity for income tax purposes, this may result in interest income to the surviving spouse, just as was the case when a third party paid interest to the credit trust. This may result in an itemized home mortgage interest deduction that will offset the resulting interest income. If one is willing to assume that the interest income and home mortgage interest deduction will offset, it could be argued that the expense of tracking these transactions is not justified. While this may often be the case, the Internal Revenue Code contains a litany of rules that may provide a contrary result.

B. Imputed Interest and the Creation of Phantom Income

The remainder beneficiaries will not likely clamor for the surviving spouse to actually make interest payments to the credit trust where it provides for mandatory income distributions back to the surviving spouse. The interest payments and the income distributions would ordinarily offset each other from a fiduciary accounting perspective.[28] As it is unlikely to make a difference to the remainder beneficiaries, the surviving spouse may be tempted to complete the transaction using an interest-free note. If no interest is actually being paid, the argument would go, the credit trust would not have any income to distribute that will be taxable to the surviving spouse as distributable net income. The problem is the risk that income may be *imputed* to the credit trust.[29]

IRC section 7872(a)(1) provides:

> "For purposes of this title, in the case of any below-market loan to which this section applies and which is a gift loan or a demand loan, the forgone interest shall be treated as
>
> (A) transferred from the lender to the borrower, and
>
> (B) retransferred by the borrower to the lender as interest."

The term "gift loan" is defined in IRC section 7872(f)(3), which states: "The term 'gift loan' means any below-market loan where the forgoing of interest is in the nature of a gift."

As applicable to this transaction, the forgoing of interest appears to be "in the nature of a gift" because it is a transfer from the credit trust to the surviving spouse for less than full and adequate consideration.[30] Moreover, the actual payment of interest by the surviving spouse could have a substantial income tax impact for the surviving spouse and the credit trust.[31] To the extent that the credit trust would specifically agree to forgo the actual payment of interest in order to avoid the payment of income taxes, IRC section 7872(c)(1) could cause the imputed interest rules of Section 7872 to apply:

> "Except as otherwise provided in this subsection, and subsection (g), this section shall apply to ...
>
> (D) Tax avoidance loans. Any below-market loan 1 of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax."

If IRC section 7872 applies, an interest-free loan would be taxed as though the credit trust made a "gift" to the surviving spouse, who then used that gift to make taxable interest payments to the credit trust.[32] These taxable interest payments will likely result in distributable net income to the surviving spouse; however, this will not necessarily have a tax neutral result.[33]

C. Imputed Interest May Impact the Surviving Spouse's Income Tax Bill

While a surviving spouse may be entitled to offset interest income with an itemized deduction for the corresponding home mortgage interest expense, that will not always be the case. "Qualified residence interest" is deductible under IRC section 163(h)(2)(D), which may be either "acquisition indebtedness" or "home equity indebtedness."[34] Interest arising out of this transaction should qualify as "acquisition indebtedness." IRC section 163(h)(3)(B)(i) provides, in relevant part:

> "In general. The term 'acquisition indebtedness' means any indebtedness which
>
> (I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and
>
> (II) is secured by such residence..."

In this transaction, the surviving spouse is acquiring a share of the residence from the deceased spouse's estate.[35] Consequently, the interest should qualify as "acquisition indebtedness" so long as the transaction is formalized in the same manner as would occur between unrelated parties.[36] The extent to which the surviving spouse will benefit from the additional home mortgage interest deduction may depend upon their particular circumstances.

The amount of acquisition indebtedness generating the home mortgage interest deduction may not exceed $1 million in a particular tax year.[37] Interest on debt exceeding this amount is non-

deductible personal interest.[38] Even if the debt will not exceed this amount, the surviving spouse may be subject to a phase out of itemized deductions, particularly when the interest income from the credit trust is added to the surviving spouse's other income.[39] The alternative minimum tax includes a deduction for qualified housing interest, similar to the home mortgage interest deduction for ordinary income tax purposes.[40] However, other deductions may be reduced or eliminated for purposes of the alternative minimum tax.[41] The net result may be that each dollar of interest income may not be offset by a deduction where the additional income causes the surviving spouse to be subject to the alternative minimum tax.

When these issues are not a concern, it does not necessarily follow that the transaction will be tax neutral. The surviving spouse will not receive an incremental benefit from the home mortgage interest deduction where he or she has no other itemized deductions. Even though the surviving spouse has an interest deduction equaling their interest income, the deduction only provides a benefit to the extent that it exceeds the standard deduction that he or she would have otherwise used. To make matters worse, adding the interest income to the surviving spouse's gross income may result in up to 85 percent of the surviving spouse's Social Security income becoming taxable.[42] This is true even though the interest income does not generate additional cash flow to pay the increased taxes.

D. Capital Gains from a Delayed Sale and Property Taxes

Note that the above examples assumed that the funding and buy back by the spouse occurred immediately. In reality, the funding of a credit trust is often delayed for a number of reasons, including: difficulty in obtaining asset or valuation information, litigation concerning the trust or its assets, the immersion of the surviving spouse in the grieving process, or the surviving spouse not having sought legal advice promptly.[43] Whatever the reason, delay may cause capital gains tax to be imposed on the sale from the credit trust to the surviving spouse, because the credit trust and the surviving spouse are generally treated as separate entities for income tax purposes. If the one-half interest held by the credit trust had increased in value from $1,000,000 on the date of death to $1,100,000 on the date of sale, the credit trust would be required to pay capital gains tax on the $100,000 gain.[44] For this reason it is imperative that the surviving spouse purchase the interest in the residence from the credit trust as soon as possible in an appreciating market.[45]

For the sake of completeness, it should be noted that the purchase of the residence by the surviving spouse should not trigger a reassessment for property tax purposes. While, generally, a change in ownership occurs as of the date of death of the property owner,[46] an exception applies to "[t]ransfers to a trustee for the beneficial use of a spouse, or the surviving spouse of a deceased transferor, or by a trustee of such a trust to the spouse of the trustor."[47]

VI. DRAFTING TO PROVIDE THE SURVIVING SPOUSE WITH AN OPTION

A. Overview

If the clients decide that it is appropriate to permit the surviving spouse to purchase an interest in the family residence from a credit trust, the practitioner may wish to include language in the trust instrument expressly authorizing that transaction in order to avoid controversy later.[48] Provided below is a form which grants the surviving spouse an option to purchase an interest in the family residence that has been allocated to the credit trust. As with any form language, the practitioner should carefully review the circumstances of each case prior to including it in an instrument. A number of factors may impact the appropriateness of this language in a particular set of circumstances.[49]

B. Form Language

A. Option to Purchase from Credit Trust. It is anticipated that, because of the total value of the Trust Estate, all or a portion of the family home, currently located at ____________________ ("the Real Property") may be allocated to the Credit Trust. It is Trustors' intent that the Survivor have the option to purchase the Decedent's interest in the Real Property, and that Trustors recognize that this transaction will result in the Credit Trust being funded with a note bearing below-market interest, secured by a deed of trust on the Real Property. Trustors further recognize that such an investment may lack diversification and liquidity, may never yield a significant distribution of income to the trust, and may constitute a very large percentage, or all, of the corpus of the Credit Trust. Nevertheless, Trustors intend that the Trustee enter into such transaction and that notwithstanding any other provision in this Trust to the contrary, the applicable Uniform Prudent Investor Act or any other rule or law which restricts a fiduciary's ability to invest insofar as any such rule or law would prohibit such transaction is hereby waived. No Trustee shall be accountable to any beneficiary for any loss or depreciation in value sustained by reason of exercise of such option.

(1) Grant of Option. If the Real Property is allocated to the Credit Trust, in accordance with paragraph A above, the Survivor shall have the option to purchase the Decedent's interest in the Real Property held by the Trust Estate at the death of the Decedent, or transferred to the Trust Estate following the death of the Decedent.

(2) Exercise of Option. The Survivor shall provide written notice to the trustee of the Credit Trust of the intent to exercise the option. The term of the option shall begin on the date of the Decedent's death and shall terminate at midnight (California time) on the date that is six months from the date of the Decedent's death.

(3) Notices and Communications. All notices and other communications authorized or required under this Option shall be in writing and shall be given by (1) personal delivery,

(2) mailing by certified mail or registered mail, return receipt requested, postage prepaid, or United States express mail, or (3) delivery by commercially recognized courier service.

(4) Purchase Price. The price at which the option may be exercised shall be the fair market value of the Decedent's interests in the Real Property as of the date upon which the option is exercised pursuant to paragraph (A)(2), above, without applying any discounts for fractional or minority interests arising solely from joint ownership with the surviving spouse.

(5) Satisfaction of Purchase Price. The Survivor may satisfy the purchase price called for under the option using a note secured by a deed of trust upon the Real Property, with principal payable in full no later than nine (9) months after the death of the Survivor, or earlier sale of the Real Property, whichever occurs first, to the extent permitted by law. The note shall bear interest at the rate of three percent (3%) per annum, but no interest shall be payable during the lifetime of the Survivor.

(6) Non-assignment of Option. This option is personal to the Survivor. The Survivor may not assign this option or any right under it. A named representative of the Survivor is expressly authorized to exercise this option on behalf of the Survivor. As used in this provision, the term "named representative" expressly includes a trustee, agent under power of attorney, or conservator of the estate for the Survivor, who is then acting in their capacity as a representative of the Survivor, but specifically excludes a bankruptcy trustee or any person appointed to act on behalf of the Survivor's creditors.

(7) Consideration. The consideration for the granting of this option is the promise of each Trustor to grant the other a reciprocal option upon the death of the other. Notwithstanding the foregoing, this option may be revoked in the same manner as the Trust, and each Trustor expressly agrees to indemnify and hold the other harmless with respect to the option.

VII. CONCLUSION

The holding of an interest in the family residence by a credit trust may be disagreeable to a surviving spouse from an emotional perspective, and disadvantageous from a tax perspective. While a number of factors should be considered before the surviving spouse purchases an interest in the family residence from a credit trust, this technique can be useful in resolving these issues. The potential purchase of an interest in the family residence is an approach that should at least be considered, both in the planning and administration stages of the estate planning process.

**Gaw Van Male, Napa*

ENDNOTES

1. It is more likely that the values of the assets will require a portion of the family residence be allocated to the credit trust in a two trust division, as opposed to a three trust division, because the residence typically represents a greater share of overall wealth in smaller estates. For that reason, the focus of this article is a two trust division. However, the mere existence of a QTIP trust would not preclude the allocation of the family residence to the credit trust and a purchase of that interest by the surviving spouse.

2. If the spouses have executed an agreement adopting the aggregate theory of community property both for assets inside and outside the trust, the percentage of assets inside the trust that must be allocated to the credit trust may be increased. For example, IRAs held outside of the trust would be taken into account for funding purposes even though they would not be available to fund the credit trust. See, generally, *California Trust Administration* Cont.Ed.Bar (2d ed. 2007) § 14.58 and Prob. Code, §§ 16246, 100-101, 104.5.

3. This example is simplified for the sake of discussion. In actual practice, a number of factors would impact the amounts actually allocated to the various subtrusts. See, e.g., *California Trust Administration, supra,* § 14.1 et seq.

4. Community Property assets generally retain their community character notwithstanding the fact that they are held by a revocable trust. Prob. Code, § 104.5 provides:

   > "Transfer of community and quasi-community property to a revocable trust shall be presumed to be an agreement, pursuant to Sections 100 and 101, that those assets retain their character in the aggregate for purposes of any division provided by the trust. This section shall apply to all transfers prior to, on, or after January 1, 2000."

5. Ensuring that the assets of the credit trust pass to the children of the deceased spouse may be of particular importance in blended families. (See, e.g., *California Will Drafting* (Cont.Ed.Bar 3d ed. 2007) § 20.4.) However, even outside of the blended family context, a credit trust may be useful to ensure that the children of the deceased spouse are not disinherited. This may happen intentionally (perhaps following remarriage by the surviving spouse), or due to fraud, undue influence, or elder abuse.

6. But see PLR 200104005, which held that the surviving spouse was an owner for purposes of IRC, § 121 of a residence held by a credit trust to the extent of the lapse of a power to withdraw the greater of $5,000 or five percent from the credit trust.

7. IRC, § 163(h)(4)(d) provides: "For purposes of determining whether any interest paid or accrued by an estate or trust is qualified residence interest, any residence held by such estate or trust shall be treated as a qualified residence of such estate or trust if such estate or trust establishes that such residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust."

8. As stated by Bryant & Warchuck, *Steps to Take to Preserve Deductions for Beneficiaries at the Termination of a Trust or Estate*, 86 J. Tax'n 51 (Jan. 1997): "As with any taxpaying or reporting entity, in some years the deductions of trusts and estates may exceed their gross income. Fiduciary deductions in excess of income are especially undesirable because the resulting loss does not pass through to beneficiaries and is not deductible in the loss year. Some of the excess deductions are lost forever, never deductible by the fiduciary or beneficiaries." Certain exceptions do exist, most notably under IRC, § 642(h) which allows for the pass through of certain deductions in the year that a trust is terminated. However, these exceptions generally will not permit the deduction of home mortgage interest under the circumstances described in the text accompanying this note.

9. IRC, § 1014 will not provide a step-up basis for the interest in the residence held by the credit trust because it will not be part of the surviving spouse's taxable estate.

10. In particular, the surviving spouse may desire to create a qualified personal residence trust in an effort to reduce or eliminate estate taxes payable upon their death. For an excellent guide to the use and operation of QPRTs, see Choate, *The QPRT Manual*, Ataxplan Publications (1st ed., 2004), available from www.ataxplan.com.

11. This is an oversimplified statement for purposes of example. A number of other factors would likely impact the amount allocated to the respective trusts in actual practice. See generally *California Trust Administration, supra,* Chapter 14.

12. Technically, the child of the deceased spouse would no longer be the stepchild of the surviving spouse because the marriage ended upon the death of the deceased spouse; however, the term "stepchild" is used here for ease of reference.

13. Prob. Code, § 16002 provides:

    "(a) The trustee has a duty to administer the trust solely in the interest of the beneficiaries.

    (b) It is not a violation of the duty provided in subdivision (a) for a trustee who administers two trusts to sell, exchange, or participate in the sale or exchange of trust property between the trusts, if both of the following requirements are met:

    (1) The sale or exchange is fair and reasonable with respect to the beneficiaries of both trusts.

    (2) The trustee gives to the beneficiaries of both trusts notice of all material facts related to the sale or exchange that the trustee knows or should know." (Emphasis added.)

14. Prob. Code, § 16003 provides:

    "If a trust has two or more beneficiaries, the trustee has a duty to deal impartially with them and shall act impartially in investing and managing the trust property, taking into account any differing interests of the beneficiaries."

15. Prob. Code, § 16004 provides:

    "(a) The trustee has a duty not to use or deal with trust property for the trustee's own profit or for any other purpose unconnected with the trust, nor to take part in any transaction in which the trustee has an interest adverse to the beneficiary.

    (b) The trustee may not enforce any claim against the trust property that the trustee purchased after or in contemplation of appointment as trustee, but the court may allow the trustee to be reimbursed from trust property the amount that the trustee paid in good faith for the claim.

    (c) A transaction between the trustee and a beneficiary which occurs during the existence of the trust or while the trustee's influence with the beneficiary remains and by which the trustee obtains an advantage from the beneficiary is presumed to be a violation of the trustee's fiduciary duties. This presumption is a presumption affecting the burden of proof. This subdivision does not apply to the provisions of an agreement between a trustee and a beneficiary relating to the hiring or compensation of the trustee."

16. Prob. Code, § 16007 provides:

    "The trustee has a duty to make the trust property productive under the circumstances and in furtherance of the purposes of the trust."

17. The list of duties potentially violated in the accompanying text is intended as illustrative, rather than an exhaustive list of all possibilities.

18. See Prob. Code, §§ 16080, 16081.

19. The settlor can restrict the application of the Uniform Prudent Investor Act by express provisions in the trust instrument. (Prob. Code, § 10646(b).) However, the degree of specificity required in the instrument is not entirely clear. One New York case attracted national attention when the trial court imposed liability notwithstanding the fact that the instrument expressly authorized the retention of a concentrated position in a publicly traded stock. While this case was reversed on appeal in *Matter of Chase Manhattan Bank* (N.Y.App.Dir 2006) 26 A.D.3d 824 [809 N.Y.S.2d 360] the fact that an appeal was required to resolve this issue illustrates that specificity is preferable where a settlor desires to authorize a specific type of investment.

20. *Hearst v. Ganzi* (2006) 145 Cal.App.4th 1195; *McKenzie v. Vanderpoel* (2007) 151 Cal.App.4th 1442.

21. This could be impacted by a number of variables, including the rate of appreciation for the residence and the length of time the surviving spouse survives. It should also be noted that the payment of accrued interest would likely generate substantial income tax liability to the credit trust upon the death of the surviving spouse, although the corresponding deduction for estate tax purposes may produce an overall tax savings (assuming the surviving spouse's estate will be subject to estate taxes).

22. *California Trust Administration, supra,* § 14A.19.

23. Among the variables to be considered are the size of the combined estate and the amount of the applicable exclusion amount upon the upon the surviving spouse's death.

24. A grantor trust is a trust that is taxed to the grantor or (in limited cases) a beneficiary, for income tax purposes, but which is not included in the estate of the grantor or beneficiary for estate tax purposes. See Zaritsky, Lane & Danforth, *Federal Income Taxation of Estates and Trusts* (WG&L 2008) ¶1.04, and IRC, §§ 671-679. Typically speaking, these types of powers are not included in a credit trust. (See, e.g., *Drafting California Revocable Trusts* (Cont.Ed.Bar 4th ed. 2007) § 14.22; Henkel, *Estate Planning and Wealth Preservation: Strategies and Solutions* (WG&L 2008) ¶4.04.)

25. *California Trust Administration, supra,* § 11.13.

26. Assuming the credit trust is a simple trust. (See Westfall & Mair, *Estate Planning Law and Taxation* (WG&L 2008) ¶14.08; Peschel & Spurgeon, *Federal Taxation of Trusts, Grantors and Beneficiaries* (WG&L 2008) ¶3.03.) In addition, it assumes that the actual income will be distributed to the surviving spouse, as opposed to a income calculated under a power of adjustment by a trustee or a unitrust conversion pursuant to Prob. Code, §§ 16336 and 16336.4.

27. As discussed in this article, interest may be imputed even where actual interest payments are not being made.

28. This assumes that there would be no unitrust conversion or adjustment between principal and income, which could either increase or decrease the fiduciary accounting income relative to the actual or imputed interest payments.

29. A detailed review of every permutation of the imputed interest rules is beyond the scope of this article. This discussion is intended merely as an overview of this subject to make the point that the purchase of an interest in a residence from a credit trust by a surviving spouse may have income tax implications.

30. While an exception exists for gift loans of $100,000 or less, this only applies "directly between individuals." (IRC, § 7872(d)(1)(A).) Because this would be a loan between a trust and an individual, it would not appear to be "directly between individuals." Moreover, the interest in the residence that is purchased by the surviving spouse will normally exceed $100,000 in any event.

31. See the discussion in this article regarding the potential income tax consequences of interest income being imputed to the credit trust.

32. The imputed interest rules appear to contemplate a transaction between two individuals, such as a parent and child. Under that scenario, the characterization of foregone interest as a gift makes sense. Where interest is foregone by a credit trust, the application of this concept is less clear. By definition, the assets of the credit trust have already passed through the estate tax system and therefore should not be subject to further estate or gift taxes. It should also be noted that the "gift" of foregone interest involves the income interest to the surviving spouse under the credit trust, and consequently does not implicate the ascertainable standards governing the distribution of principal. If interest is imputed under IRC, § 7872, the rate of interest would depend upon the terms of the note. (IRC, § 7872(f)(2).)

33. IRC, § 163(h)(3)(A) provides that "[t]he term 'qualified residence interest' means any interest which is paid *or accrued* during the taxable year..." (emphasis added). As a result, the fact that the surviving spouse did not actually make payments to the credit trust will not necessarily preclude the use of the home mortgage interest deduction. However, if one is inclined to take the position that the imputed interest has not "accrued," perhaps the argument could be made that the surviving spouse would not be entitled to a home mortgage interest deduction. This would be a truly disastrous income tax result for the surviving spouse.

34. IRC, § 163(h)(3)(A).

35. The deceased spouse has the right to leave his or her half of the community property to someone other than the surviving spouse. (Prob. Code, § 100-101.) By creating the credit trust, that is effectively what they have done.

36. Specifically, this would mean that the purchase of an interest in a residence would be secured by a note and deed of trust.

37. IRC, § 163(h)(3)(B)(ii) provides: "The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return)."

38. IRC, § 163(h)(2).

39. IRC, § 68.

40. IRC, § 56(e).

41. See IRC, § 56(b).

42. IRC, § 86.

43. In some instances, this may be the product of the "living trust myth" (e.g., an administration is unnecessary where one has a living trust. (*California Trust Administration, supra,* § 13.23).

44. This should not be confused with *Kenan* gain. Under Treas. Reg. § 1.661(a)-2(f)(1) and § 1.1014-4(a)(3); Rev. Rul. 56-270, 1956-1 C.B. 325; Rev. Rul. 60-87, 1960-1 C.B. 286; *Kenan v. Comr.*, 114 F.2d 217 (2d Cir. 1940), the satisfaction of a pecuniary bequest with assets in kind is a taxable event. In other words, it is essentially treated as though the assets were sold for their fair market value (potentially resulting in the imposition of income or capital gains tax) followed by a distribution of cash to beneficiary. As applicable in the subtrust funding context, this means that the funding of a subtrust using a pecuniary formula with date of distribution values will result in a taxable gain. Appreciation in the value of the residence will result in the imposition of a capital gains tax when the surviving spouse buys the residence back, even where the subtrust to which the residence is allocated does not have a pecuniary formula. While the survivor's buy back of the residence may trigger capital gains taxes, this operates independently of the capital gains imposed under *Kenan*. It should be noted that the basis for the purposes of the interest in the community property residence will be its fair market value as of the date of death for the first spouse. (IRC, § 1014.)

45. It is not necessary for the appraisal to be completed in order for this to occur. Rather, the surviving spouse and the trustee of the credit trust may agree that the interest in the residence will be sold at its value as of the date of the sales agreement is entered into, with the actual value to be determined by a subsequent appraisal.

46. Rev. & Tax. Code, §61; 18 Cal. Code Regs. §462.260(c).

47. Cal.Const.Art. XIIIA, §2(g)(1).

48. This is particularly true in blended families or other circumstances where the potential for conflict is relatively high.

49. For example, one issue is whether to designate a particular property as the family residence over which an option is to be granted. It may be possible to include language permitting the surviving spouse to purchase an interest in a subsequently acquired residence. However, this could lead to controversy over whether a particular residence is the "family residence," as opposed to a vacation residence. By identifying a specific property as the "family residence" this potential controversy may be avoided, but may leave the surviving spouse without an option over a subsequently acquired residence.

Check out the Trusts and Estates Section's website for information on:

- Proposed and Pending Legislation
- Upcoming Live Programs
- Current and past issues of Trusts and Estates Quarterly – available online
- Link to Senior Abuse Hotline
- Online CLE
- Statutory Will Form
- Ordering Estate Planning Brochures ("Do I Need a Will?", "Do I Need a Living Trust?", "Do I Need Estate Planning?")