Chapter 1

What is a Trust? What is an Estate?

Learning objectives

- Identify the elements of a trust.
- Recognize the difference between a trustee and a trustor.
- Distinguish between probate and nonprobate assets.
- Recall the basics of trust and estate administration.

Introduction

This course will provide a comprehensive look at the income taxation of trusts and decedents' estates and the beneficiaries of trusts and estates under the IRC. Trusts and estates are treated as separate taxable entities under the IRC, and they are unique in the way they are treated. Essentially, trusts and estates are what might be termed "semi-conduits." That is, to the extent that they retain income, they are taxed on that income, and to the extent that they distribute income to the beneficiaries, the beneficiaries are taxed. Before we discuss in detail the taxation of trusts and estates, and the beneficiaries of each, you must first have an understanding of these entities, how they are created, and how they operate.

What is a trust?

Definition of a trust

A trust is a legal contract between the creator and the trustee for the benefit of another individual, a charitable organization, or an animal. The trustee has a fiduciary duty to abide by the terms in the trust agreement. The creator of the trust is often referred to as the settlor, grantor, or trustor. When a trust is created, the trustee takes legal title and management power over the trust property.[1] The individual, organization, or animal that is benefited by trust is called the beneficiary.

Terms of the trust

The settlor's intentions in regard to how the trust property is to be held, administered, and distributed for the benefit of the trust beneficiaries are referred to as the "terms of the trust."[2] If the trust is evidenced by a written agreement, or in the settlor's last will and testament, the terms of the trust will be provided in the trust agreement or the will.

Methods of creating a trust

A trust may be created by a transfer in trust made in the settlor's will (a *testamentary* trust), or a transfer in trust during the settlor's lifetime (an *inter vivos* trust). A trust can also be created by a simple declaration by the settlor that he or she holds property as trustee, or by the exercise of a power of appointment appointing property to a person as trustee.[3]

Requirements to form a valid trust

In general

Under the Uniform Trust Act, a trust can only be created if all of the following are present:

- The settlor is of the age of majority.
- The settlor has capacity.
- The settlor has the intention to create a trust.
- There is a beneficiary.
- The trustee has duties to perform.
- The settlor, trustee, and beneficiary are not the same person.

These requirements will be discussed in detail in the following material.

Age of majority

The settlor must be the age of majority when the trust is created. The age of majority will be determined by state laws that govern the trust. Typically, the age of majority is either 18 or 21.

[1] Jesse Dukeminier, Stanley M. Johanson, James Lindgren & Robert H. Sitkoff, Wills, Trusts, and Estates 485 (7th ed., 2005).
[2] Restatement (Third) of Trusts Section 4.
[3] Uniform Trust Code (UTC) Section 401.

Capacity

In order to create a trust, the settlor must have the requisite mental capacity. The level of mental capacity will differ depending upon if the trust is a revocable or irrevocable trust as well as which state the trust is created in.

Intention to create a trust

There must also be an outward expression by the trust settlor of his or her intention to create a trust. No particular words are required to create the trust and the words may be written or spoken.[4]

Definite beneficiaries

A trust must have definite beneficiaries. A beneficiary is definite if the beneficiary can be determined, either now or in the future. If the trustee has the power to select a beneficiary from an indefinite class, that is valid. If the power is not exercised within a reasonable time however, the power fails and the property subject to the power passes to the persons who would have taken the property had the power not been conferred. Many dynasty trusts are created with the intent to benefit all future generations for as long as the trust can exist, as governed by the applicable state law.

Duties to perform

A trust is only created if the trustee has duties to perform.[5] Trustee duties are usually active, requiring that the trustee do something, but a duty may also be passive, implying only that the trustee has an obligation not to interfere with the beneficiary's enjoyment of the trust property.[6]

Formalities of execution

The validity of a trust created by will is ordinarily determined by the law of the decedent's domicile. In other words, if the will creating the trust is valid in the jurisdiction where it was executed, the trust is also valid.[7] In regard to the law regarding the validity of inter vivos trusts, the law is less certain.[8] The Restatement (Third) of Trusts provides that except where required by the Statute of Frauds, no writing is required to create a valid trust.[9] However, not all jurisdictions recognize oral trusts. Pennsylvania, for example, does not recognize oral trusts. In cases when writing is required, it is sufficient to satisfy the statute if it is signed by the settlor.

Trust purpose

A trust may be created only for purposes that are lawful, not contrary to public policy, and not impossible to achieve.[10] A trust may be created for charitable or noncharitable purposes, or for a combination of the

[4] Restatement (Third) of Trusts Section 13, comment b.
[5] Restatement (Third) of Trusts Section 2.
[6] Restatement (Third) of Trusts Section 6.
[7] Restatement (Third) of Trusts Section 17.
[8] UTC Section 403, comment.
[9] Restatement (Third) of Trusts Section 17, Comment. Generally, under the Statute of Frauds, a signed writing is required for contracts involving the transfer of land. The Statute applies not only to a contract to sell land but also to any other contract in which land or an interest in it is disposed, such as the grant of a mortgage, an easement, or a trust.
[10] UTC Section 404.

two.[11] A charitable trust may be created for the relief of poverty; advancement of education or religion; promotion of health, governmental, or municipal purposes; or other purposes for which the achievement is beneficial to the community.[12]

A trust or a particular trust provision is invalid if

- its purpose is unlawful or its performance calls for the commission of a criminal or tortious act;
- it violates rules relating to perpetuities;[13] or
- it is contrary to public policy.[14]

The fact that the trust purpose cannot be achieved by lawful means will not necessarily invalidate the trust if there is a substantial valid purpose that can be achieved by methods that are not unlawful. This will not be the case if the purpose or method directed is so essential to the settlor's objective(s) that the permissible and impermissible purposes cannot be separated.[15]

Finally, a noncharitable private trust, or a particular provision in the trust, may be invalid because all the purposes for which a trust is created are so indefinite that they cannot be enforced. Also, if the trust purposes are impossible to perform, the trust will be terminated.

The fiduciary duty

The "trustee" is the person or entity that holds legal title to the trust property and manages that property for the sole benefit of the trust beneficiary or beneficiaries. The interests of the beneficiaries are protected under the law against mismanagement or misappropriation by the trustee.[16] In performing its duties, the trustee is held to a "fiduciary standard" of conduct. Fundamentally, the fiduciary standard requires a duty of loyalty and a duty of prudence. This means that the trustee must act for the sole benefit of the trust beneficiaries and in a prudent manner in administering the trust. The trustee must also exercise *the same care and skill as a man of ordinary prudence would exercise in dealing with his own property*,[17] *and act in a manner which makes the trust property productive*.[18]

The fiduciary standard also includes a host of subsidiary duties which act to reinforce the duties of loyalty and prudence.[19] Those duties include the duty to keep accurate records with respect to the

[11] Restatement (Third) of Trusts Section 27.
[12] UTC Section 405.
[13] Restatement (Third) of Trusts Section 29, Comment g. The rule against perpetuities regulates remoteness of vesting. It applies to the equitable interests of trust beneficiaries. Under the rule, no trust interest is valid unless, by the terms and time of its creation, it is certain to vest or fail no later than 21 years after some life in being at the creation of the interest. As a result, a private trust, for example, will fail unless the trust has one or more definite beneficiaries or provides for one or more beneficiaries to be ascertained within the requirements of the applicable rule against perpetuities.
[14] Restatement (Third) of Trusts Section 29.
[15] Restatement (Third) of Trusts Section 29, Comment e.
[16] Dukeminier, at 490.
[17] Restatement (Second) of Trusts Section 174.
[18] Restatement (Second) of Trusts Section 174.
[19] Dukeminier, at 491.

administration of the trust,[20] and to provide complete and accurate information to the trust beneficiaries concerning the nature of the trust property upon reasonable request.[21]

Nature and extent of trustee's duties

The nature and extent of a trustee's duties is determined first by the trust agreement, and then in areas not addressed by the trust agreement by the law governing the trust.[22] In carrying out this responsibility, the trustee has what is called a *fiduciary duty* to the trust beneficiary or beneficiaries. Generally, the trustee is charged with the responsibility of administering the trust property solely in the interest of the trust beneficiaries.[23] If there is more than one trust beneficiary, the trustee must deal with them all impartially.[24]

The trustee is generally entitled to reasonable compensation for performing its duties as trustee.[25] Often the trustee's compensation is based on a percentage of the value of the trust assets. The trustee must also keep accurate records with respect to the administration of the trust[26] and provide complete and accurate information concerning the nature of the trust property upon reasonable request.[27]

Investments of the trust

Sometimes the trust document will provide specifically how the trust principal is to be invested (for example, only in "*triple A-rated bonds*"). However, most of the time, the document will not specifically direct the trustee as to how to make investments; instead, the manner in which they are made is controlled by the trustee's fiduciary duty and the terms of the Uniform Prudent Investor Act (UPIA). Under the terms of the UPIA, the trustee is not restricted to one type of investment but may invest in a manner which is prudent and consistent with the trust purpose. Under the UPIA, the trustee's performance will be judged not on the basis of a single investment but rather on the basis of *total return* of the entire trust portfolio. The underlying premise of this approach is to allow trustees to use modern portfolio theory in analyzing risk versus return.

Breach of duty

If, in managing the trust, the trustee breaches the trustee's fiduciary duty and causes damage to the trust, the trustee can be held liable for the loss ("surcharged").[28]

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[20] Restatement (Second) of Trusts Section 172.
[21] Restatement (Second) of Trusts Section 173.
[22] Restatement (Second) of Trusts Section 164.
[23] Restatement (Second) of Trusts Section 170(1).
[24] Restatement (Second) of Trusts Section 183.
[25] Restatement (Third) of Trusts Section 38.
[26] Restatement (Second) of Trusts Section 172.
[27] Restatement (Second) of Trusts Section 173.
[28] UTC Section 1001.

The tax definition

The regulations

The regulations define a "trust" for tax purposes in a manner consistent with the legal definition discussed previously; that is a trust is "as an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."[29]

Generally, an arrangement will be treated as a trust under the IRC if it can be shown that the purpose of the arrangement is to vest in the trustees' responsibility for the protection and conservation of property for beneficiaries (that is, fiduciary duty) who cannot share in the discharge of this responsibility, and therefore, are not associates in a joint enterprise for the conduct of business for profit.[30]

Other entities

In addition to what might be termed *ordinary trusts*, there are other entities which are referred to as a trust, which may or may not be treated as a "trust" under the IRC. These include the following.

Business trusts

Entities known as *business* or *commercial trusts* are generally created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships. The fact that an organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, does not change the real character of the organization if the organization is more properly classified as a business entity.[31]

Investment trusts

A so-called "investment trust" will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. An investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power under the trust agreement to vary the investment of the certificate holders.[32]

Liquidating trusts

A *liquidating trust* may be recognized as a trust for tax purposes if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose.[33]

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[29] Treas. Reg. Section 301.7701-4(a).
[30] *Id*.
[31] Treas. Reg. Section 301.7701-4(b).
[32] Treas. Reg. Section 301.7701-4(c)(1).
[33] Treas. Reg. Section 301.7701-4(d).

Environmental remediation trusts

An *environmental remediation trust* is considered a trust for tax purposes if the organization is organized under state law as a trust; the primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws; all contributors to the trust have (at the time of contribution and thereafter) actual or potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and the trust is not a *qualified settlement fund*, as defined by the regulations.[34]

Knowledge check

1. What is generally not recognized as a *trust* for tax purposes?

    a. An investment trust.
    b. A business trust.
    c. An environmental remediation trust.
    d. A liquidating trust.

2. What best describes the trustee's fundamental fiduciary duty to the trust beneficiaries?

    a. The fiduciary standard requires a duty of loyalty and a duty of prudence.
    b. The fiduciary standard requires the trustee to communicate with the trust beneficiaries.
    c. The fiduciary standard requires the trustee to keep good records.
    d. The fiduciary standard requires that the trustee perform its duties without compensation.

The law governing the trust

In general

The law that governs the administration of a particular trust is generally determined by the jurisdiction designated in the trust, or absence such a designation, by the law of the jurisdiction with the most significant relationship to the matter at issue.[35] This generally means the state law of the state in which the trust is subject to administration. Many states have adopted the Uniform Trust Code (2000) (UTC) as their governing law in one form or another. The UTC represents an effort to create a uniform model of the law of trusts. Another source of reference, particularly in areas not addressed by local law, is the Restatement (Third) of Trusts. The restatement is a treatise published by the American Law Institute, which summarizes the common law; that is, the law as developed by court decision rather that statutory law. The restatement attempts to resolve conflicts where they may exist among different jurisdictions, and also provides guidance if existing law does not address a particular issue.

[34] Treas. Reg. Section 301.7701-4(e)(1).
[35] UTC Section 107.

The Uniform Principal and Income Act (UPIA[36]) is another statute that affects the administration of both trusts and estates. The purpose of the UPIA is to provide procedures by which fiduciaries administering trusts and estates account for receipts and payments to principal and income of a trust or estate (also known as *fiduciary accounting*).

Finally, the UPIA deals with guidance in regard to the exercise of fiduciary investment decisions. The UPIA has been adopted in 44 states and the District of Columbia. Other states have adopted parts of the act, but not the entire act. The approach under UPIA allows fiduciaries to use modern portfolio theory to guide investment decisions and requires risk versus return analysis. As a result, a fiduciary's investment performance is evaluated based on the performance of the entire portfolio, rather than individual investments.

Situs

Where a trust has *situs* determines the jurisdiction of the courts regarding matters involving a trust.[37] Situs is generally established by a provision in the trust instrument provided either

- the trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction;
- all or part of the trust administration occurs in the designated jurisdiction; or
- one or more of the beneficiaries resides in the designated jurisdiction.[38]

Absent a trust provision, establishing situs in a particular jurisdiction will depend on such factors as whether the trust was a testamentary or inter vivos trust, where the trustee has its principal place of business, and where all or part of the trust administration occurs.[39]

The term of a trust

The trust agreement may provide for a specific term of the trust. For example, a trust agreement may provide that the trust will end after a specified period of time has elapsed, such as 20 years after the formation of the trust. The trust agreement may also state that the trust will end upon the occurrence of a specified event, for instance, the beneficiary reaching the age of 21. In addition, the settlor may retain the power to revoke the trust or vest that power in the trustee or other named party, even the trust beneficiaries. Generally, a settlor may revoke or amend a trust unless the trust instrument expressly

[36] According to the Uniform Law Commission (ULC, also known as the National Conference of Commissioners on Uniform State Laws), The Uniform Principal and Income Act is abbreviated as UPIA. However, many publications and professionals will also use the acronym UPAIA when referring to this Act. The complete text of the Act is available on the ULC site, here: https://www.uniformlaws.org.
[37] UTC Section 202. Note this is a different question than which law applies. Here the question is which court will hear issues regarding a trust. In some cases, one state's law will govern the trust (because the document so provides) but another state's court will interpret and apply that law (because the trust has situs in that state).
[38] See, for example, 20 Pa.C.S.A. Section 7708(a).
[39] See, for example, 20 Pa.C.S.A. Section 7708(b).

provides that the trust is irrevocable.[40] The UTC also contains provisions which permit termination and modification of a trust with or without court approval.[41] Absent specific provisions in the trust document, a trust will terminate when no purpose of the trust remains to be achieved, or the purposes of the trust have become unlawful or contrary to public policy.[42]

Rule against perpetuities

Under the law of many states, a trust must terminate under what is known as the *rule against perpetuities*. This rule originated as a part of the law, which first developed the legal concept of what a trust is and how it is to be administered. Under the rule, a trust must end no later than the death of the last trust beneficiary living upon the creation of the trust plus 21 years. Some states have specifically revoked the rule, and in those states, a trust can theoretically last forever (in perpetuity).

At the time that this course was written, the following 29 states and the District of Columbia allow for trusts to continue well past the previously listed limitations and in most cases, continue into perpetuity.

- Alaska
- Arizona
- Arkansas
- Colorado
- Delaware
- District of Columbia
- Florida
- Hawaii
- Idaho
- Illinois
- Kentucky
- Maine
- Maryland
- Michigan
- Missouri
- Nebraska
- Nevada
- New Hampshire
- New Jersey
- North Carolina
- Ohio
- Pennsylvania
- Rhode Island
- South Dakota
- Tennessee
- Utah
- Virginia

[40] See UTC Section 602(a).
[41] See UTC Sections 410-416.
[42] See UTC Section 410(a).

- Washington
- Wisconsin
- Wyoming

Term for tax purposes

For tax purposes, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting.

A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust.

However, the winding up of a trust cannot be unduly postponed, and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. Further, a trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).[43]

The trust agreement

In most cases, the terms of the trust are governed by a written trust agreement. To reiterate, oral trusts are also recognized in some situations; however, in most states that have adopted the Uniform Trust Act, an oral trust is only recognized if there is clear and convincing evidence a trust was created.[44] The specific terms under which the trustee deals with the investment of the trust corpus and distribution or retention of the trust income and principal to the trust beneficiaries is generally stated in the trust agreement. The trust can either be established during the lifetime of the settlor of the trust (an inter vivos trust) or under the settlor's will (a testamentary trust).

A typical trust agreement will contain the following seven trust provisions:

- *The declaration of trust* — This is the provision that meets the requirement that the trust settlor manifests the intention to create a trust. For example:
  - Settlor hereby delivers to trustee the assets listed in Schedule A, to be held, invested, and distributed pursuant to the terms of this trust agreement, together with any other property that may be added hereto.

[43] Treas. Reg. Section 1.641(b)-(3)(b).
[44] UTC Section 407.

- *A statement of trust purpose* — Sometimes this provision will be omitted, but if it is included in the trust agreement, it will provide valuable guidance to the trustee and the courts as to the settlor's intent as to how the trust should be administrated. For example:
  - It is the settlor's intent in establishing this trust to care for the maintenance and support of his wife before all others, and the trust shall be administered for that purpose.
- *A statement of revocability or irrevocability* — Under the UTC, a trust is revocable unless it states that it is irrevocable. However, the trust agreement should include either of the following provisions to make the intention clear:
  - This trust shall be irrevocable and the settlor hereafter shall have no right to alter, amend, or revoke this trust in any manner whatsoever.

    Alternatively:

  - This trust shall be revocable and the settlor specifically reserves the right to alter, amend, or revoke this trust at any time.
- *Dispositive provisions* — The dispositive provisions provide how income and principal are to be held and distributed during the term of the trust, and also how and to whom the balance of the trust assets are to be distributed upon the termination of the trust. Here is some illustrative language:
  - During the lifetime of the settlor's wife, the trustee shall pay and distribute to her or for her benefit the entire net income of this trust, of which payments shall be made to her no less frequently than quarterly. In addition, the trustee shall from time to time pay to the settlor's wife, or shall apply directly for her benefit, as much of the principal of this trust as the trustee, in its absolute discretion, may consider desirable for her health, maintenance, and support.

    Upon the death of the settlor's wife, the remaining balance of the trust shall be distributed outright and free of trust to the settlor's then living issue, in equal shares.

- *Administrative provisions* — The administrative provisions will generally grant powers of administration to the trustees which are in addition to those provided under the governing law. The intention of adding these provisions is to generally facilitate the administration of the trust without unnecessary court involvement.
  - Administrative powers:

    In addition to the powers conferred on the trustee under 20 Pa. C.S. Section 7780.5, which shall include all of the illustrative powers provided in 20 Pa. C.S. Section 7780.6, the trustee shall have the following powers until all property is distributed:

    - To retain any real or personal property (including stock of any corporate trustee or of a company controlling it) in the form in which it is received
    - To hold property unregistered or in the name of a nominee
    - To buy real and personal property from the personal representatives of the settlor's estate, and to lend money to them upon such terms and conditions as the trustee deems advisable, even if the settlor's personal representative is also a trustee of this trust

- *Trustee provisions* — The trustee provisions normally name successor trustees, and also may deal with such matters as procedures for removal of trustees, and how they are to be compensated.
  - Upon the death of the settlor, the settlor's wife, by signifying her acceptance in writing, shall become a trustee hereunder. Any successor trustees shall have all the powers conferred upon the originally named trustees except those powers expressly limited to the disinterested trustee.
- *Governing and situs* — This provision will establish the situs of the trust, and the law which shall govern the administration of the trust:

– The situs of this trust shall be the Commonwealth of Pennsylvania. Questions pertaining to the validity, construction, and administration of the trusts created under this instrument shall be determined in accordance with the laws of the Commonwealth of Pennsylvania.

How a trust operates

Beginning with the initial funding of the trust, and ending upon the termination of the trust at the point when the trust assets are distributed, the trust assets are subject to the administrative control of the trustee. During the period of administration, the trustee is required to invest the corpus or principal of the trust, and distribute the income and principal of the trust according to the terms of the trust document.

Example 1-1

Mr. Wilson wishes to create a trust for the benefit of his grandson, Tim, age 18, to assist in funding Tim's education. Mr. Wilson has his lawyer draft a trust agreement consistent with this purpose. The terms of the trust as provided in the trust agreement state that Mr. Wilson's friend Steve is appointed trustee of the trust.

During the term of the trust, the $100,000 is to be invested by the trustee, and the trustee is to distribute trust income at least annually to Tim. The trustee may also distribute trust principal if needed to provide for Tim's "educational needs, as deemed appropriate by the trustee." The trust is to terminate and the remaining trust balance is to be distributed outright and free of trust to Tim, upon Tim attaining his 21st birthday.

Upon execution of the trust document, Mr. Wilson transfers $100,000 to the trust by writing a check for $100,000 to "Mr. Steve, as trustee of the trust established for the benefit of Tim." Mr. Steve establishes an investment account with ABC Bank, in the trust name, and deposits the check. A tax identification number is obtained on behalf of the trust. The $100,000 originally funding the trust makes up the original corpus or principal of the trust. Mr. Steve invests the $100,000 in a certificate of deposit paying 3 percent interest a year. The interest earned will be the income of the trust.

The trustee must make distributions to Tim as provided in the trust document — therefore income must be distributed on an annual basis, and principal if needed for the "education" of Tim. Each year, Steve distributes the interest income earned by investment of the trust principal. At age 20, Tim enrolls in college, and the trustee pays the first-year tuition from the principal of the trust. Steve is not permitted to distribute principal for any other purpose than as provided in the trust, until Tim reaches age 21, at which point the trust is to end and the remaining trust balance is to be distributed to Tim.

In addition, the trustee has a duty to keep adequate records of administration of the trust assets and to respond to requests for information related to the trust's administration. During the term of the trust, the trust is a taxpayer and Steve must file tax returns on behalf of the trust. The income earned by the trust must be reported on that tax return.

In addition, there will be costs incurred by the trust, such as the trustee's compensation and accounting fees. Similar to individual taxpayers, these costs may be deductible for tax purposes on the trust's tax return when determining the trust's taxable income.

Definitions

The following definitions are relevant to trusts:

- *Trustee* — One who stands in a fiduciary or confidential relation to another; especially one who, having legal title to property, holds it in trust for the benefit of another and owes a fiduciary duty to that beneficiary.[45]
- *Settlor*, *grantor*, *trustor* — Someone who creates a trust.[46]
- *Beneficiary* — A person for whom benefit property is held in trust.[47]
- *Revocable trust* — A trust in which the settlor reserves the right to terminate the trust and recover the trust property and any undistributed income.[48]
- *Irrevocable trust* — A trust that cannot be terminated by the settlor once it is created.[49]
- *Principal* — The corpus of the trust.[50]
- *Income* — Amounts earned by the principal of the trust.
- *Remainder interest* — The property that passes to a beneficiary after the expiration of an intervening income interest.[51]
- *Remainderman* — Individual or entity entitled to the remainder interest.[52]
- *Testamentary trust* — A trust that is created by a will and takes effect when the settlor (testator) dies.[53]
- *Inter vivos or living trust* — A trust that is created and takes effect during the settlor's lifetime.[54]
- *Situs* — The location or position (of something) for legal purposes.[55]
- *Rule against perpetuities* — The common-law rule prohibiting a grant of an estate unless the interest must vest, if at all, no later than 21 years (plus a period of gestation to cover a posthumous birth) after the death of some person alive when the interest was created. The purpose of the rule was to limit the time that title to property could be suspended out of commerce because there was no owner who had the title to the property and who could sell it or exercise other aspects of ownership. If the terms of the contract or gift exceeded the time limits of the rule, the gift or transaction was void.[56]

[45] Black's Law Dictionary (9th ed. 2009).
[46] *Id*.
[47] *Id*.
[48] *Id*.
[49] *Id.*
[50] Ballentine's Law Dictionary (2010).
[51] Black's Law Dictionary (9th ed. 2009).
[52] *Id*.
[53] *Id*.
[54] *Id*.
[55] *Id*.
[56] *Id*.

Knowledge check

3. When does an estate begin and end for tax purposes?

    a. The estate begins on the date of death and lasts for any period of 12 months or less, that ends on the last day of a month.
    b. The estate begins on the date of the decedent's death and ends when the final income tax return is filed on behalf of the estate.
    c. The estate begins on the date of the decedent's death and ends when the executor or administrator has performed the ordinary duties of administration.
    d. An estate begins on probate of the will and ends when the probate assets are distributed according to the terms of the will.

Decedent’s estates

The probate estate

A decedent’s estate comes into existence at the time of an individual’s death. For purposes of administration, a decedent’s estate only consists of the decedent’s *probate assets*. Probate assets can be generally defined as the property that the client owns solely in his or her own name alone. Assets that are disposed of through the designation of a beneficiary, such as IRAs, 401(k)s, qualified retirement plans, annuities, and life insurance do not fall within the definition of probate property. These assets are termed *nonprobate property*.

Probate property also does not include property that the client owns jointly with the right of survivorship with another party. Joint property does not pass according to the terms of a will, but will pass to the surviving joint owner automatically upon death by operation of law. In most cases, joint property will be designated as such with the names of the owners and the phrase following their names “Joint Tenants with Right of Survivorship” (JTWROS).[57]

The administration process

Overview

After the death of an individual, the executor of the estate as named in the will, or in the case of an individual who dies without a will, the estate administrator, is generally charged with taking control of the decedent’s assets, paying the decedent’s debts and expenses including inheritance taxes, and finally distributing the remaining assets under the terms of the will, or intestate law if there is no will.

This period of administration or probate begins with the probate of the will and the appointment of the individual or entity named in the will as the estate executor. Probate of the will generally involves presentation of the document to the Register of Wills. If someone wishes to contest the validity of the will, he or she must do so within a limited time period after the will is presented for probate.

If someone dies without a will, he or she are said to die *intestate*. In that case, the court will appoint an administrator to administer the estate. The administrator is typically the decedent’s closest living relative.

Executor’s duty

During the period of the administration of the estate, the executor or administrator must take control of the probate assets. Like a trustee, the estate executor bears a fiduciary responsibility to the heirs of the

[57] Joint property, which passes by right of survivorship, should be distinguished from property held by two or more owners as *tenants in common*. If the property is held by a husband and wife, the property is presumed to be held jointly with the right of survivorship even without that joint designation (that is, “joint with right of survivorship” or JTWOS). If the property is held by joint owners other than husband and wife without the right of survivorship designation, the property is presumed to be held as *tenants in common*. Property held as tenants in common is deemed to be owned one-half by each owner and will pass as a probate asset under their respective wills, or by Intestacy.

estate to make sure that the assets making up the estate are properly maintained and invested during the period of estate administration. During this period, the estate is a taxpayer and must file a tax return reporting the taxable income earned by the estate assets, and pay tax on that income as well. The administration of the estate will end upon the final distribution of the estate assets.

Estates for tax purposes

It is the probate assets which comprise the "estate" for income tax purposes, and the income earned by the assets and the expenses incurred in administration of those assets during the period the estate is in existence which are reportable on the estate income tax return, Form 1041. For tax purposes, the estate begins on the date of the decedent's death[58] and ends when the executor or administrator has performed the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).[59] The period between the date of death and closing of the estate is sometimes referred to as the period of the *administration* of the estate or *probate*.

Example 1-2

Mr. Warren dies with the following assets with fair market values as indicated:

Stock	$ 100,000
Bonds — taxable	50,000
Bonds — tax-exempt	25,000
Personal property	5,000
Rental property	300,000
Operating business	800,000
Partnership interest	25,000
Life insurance	$ 500,000
IRA	325,000

[58] See instructions to Form 1041 (2016), p. 9.

[59] Treas. Reg. Section 1.641(b)-3(a). Notwithstanding the aforementioned, if the estate has joined in making a valid election under Section 645 to treat a qualified revocable trust as defined under Section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the Section 645 election period. See Section 645 and the regulations thereunder for rules regarding the termination of the Section 645 election period.

Example 1-2 (continued)

Mr. Warren's will provides that his estate will be divided into equal shares and distributed to his four children. Under the will, Mr. Warren's son, James is appointed executor of the estate. His probate estate will consist of all his assets except the life insurance and the IRA — these two assets will be distributed according to their designations of beneficiary and not under the terms of Mr. Warren's will. As the executor of Mr. Warren's estate, James will have the responsibility to take control of the probate assets, and make sure they are maintained during the period the estate is being administered. He will also have to pay from the probate assets any debts which Mr. Warren owed at the time of his death, and any costs of administering the estate out of the probate assets. He must also collect any income earned on those assets during the period of administration of the estate. This income offset by allowable deductions is the income reportable on the estate income tax return during the period of administration of the estate. At the end of the period of administration of the estate, the executor will distribute the remaining probate assets to Mr. Warren's four children in equal shares as provided in the will, and the estate will be closed.

Definitions

- *Testator* — A person who has made a will; esp., a person who dies leaving a will.[60]
- *Devise* — To give (property) by will.[61]
- *Bequest* — (1) The act of giving property (usually personal property) by will; (2) Property (usually personal property other than money) disposed of in a will.[62]
- *Executor (or Executrix)* — (1) One who performs or carries out some act; (2) A person named by a testator to carry out the provisions in the testator's will.[63]
- *Intestacy* — The state or condition of a person having died without a valid will.[64]
- *Personal effects* — Items of a personal character, especially personal property owned by a decedent at the time of death.[65]
- *Administrator* — A person appointed by the court to manage the assets and liabilities of an intestate decedent.[66]
- *Residue* — The part of a decedent's estate remaining after payment of all debts, expenses, statutory claims, taxes, and testamentary gifts (special, general, and demonstrative) have been made.[67]
- *Specific gift* — A bequest of a specific or unique item of property, such as any real estate or a particular piece of furniture.[68]

[60] Black's Law Dictionary (9th ed. 2009).
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *Id.*

- *General gift* — (1) A bequest of a general benefit, rather than a particular asset, such as a gift of money or a gift of all the testator's stocks; (2) A bequest payable out of the general assets of the estate.[69]
- *Probate assets* — A decedent's asset that by law is subject to the claims of creditors or legacies.[70]
- *Nonprobate assets* — Property that passes to a named beneficiary upon the owner's death according to the terms of some contract or arrangement other than a will. Such an asset is not a part of the probate estate and is not ordinarily subject to the probate court's jurisdiction (and fees), although it is part of the taxable estate. Examples include life-insurance contracts, joint property arrangements with right of survivorship, pay-on-death bank accounts, and inter vivos trusts.[71]

Knowledge check

4. Which of the following is *not* required to form a trust?

   a. The settlor must have the requisite capacity.
   b. An indication by the settlor of an intention to create a trust.
   c. A charitable purpose.
   d. A definite beneficiary.

[69] *Id*.
[70] *Id*.
[71] *Id*.

